

No. 17050

United States
Court of Appeals
for the Ninth Circuit

BAY COUNTIES TITLE GUARANTY CO.
(formerly BAY COUNTIES ESCROW CO.),
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of Record

Petition to Review a Decision of The Tax Court
of the United States.

FILED

NOV - 4 1960

FRANK H. SCHMID, CLERK



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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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NAMES AND ADDRESSES OF ATTORNEYS

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JOSEPH S. ROGERS,

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San Francisco 4, California,

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Attorneys for Petitioner.

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Assistant U. S. Attorney,

LEE A. JACKSON,
Attorney,

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Washington 25, D. C.,

Attorneys for Respondent.

The Tax Court of The United States

Docket No. 63623

BAY COUNTIES TITLE GUARANTY COMPANY,
(formerly BAY COUNTIES ESCROW COMPANY), Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DOCKET ENTRIES

1956

Aug. 2—Petition received and filed. Taxpayer notified. Fee paid.

Aug. 6—Copy of petition served on General Counsel.

Sept. 11—Answer filed by Resp. Served 9/12/56.

Sept. 11—Request for hearing in San Francisco filed by Resp. 9/12/56 Granted.

1957

Oct. 22—Notice of Trial Jan. 20, 1958, at San Francisco.

1958

Jan. 20—Petr's motion for Cont. filed at trial—Granted without obj. Cont'd generally. Served at trial 1/21/58.

June 27—Notice of Trial Oct. 6, 1958, San Francisco.

1958

July 1—Application for order to take deposition of Ralph N. Kleps, on written interrogatories, by Petr. Denied 7/17/58.

July 2—Notice of application to take deposition on written interrogatories, filed. Served 7/3/58.

July 16—Resp. objections to Petr's application for Order to take Depositions on written interrogatories.

July 17—Order that Petr's application for Order to take deposition on written interrogatories is denied.

Oct. 8, 9—Trial before Judge Harron — San Francisco.

14—Stip of facts filed at trial.

—Briefs due Nov. 24, 1958.

—Reply Briefs due Dec. 24, 1958.

Oct. 29—Transcript of Proceedings 10/8, 10/9, and 10/14/58 filed. 3 vols.

Nov. 24—Petr's Brief filed. Served 12/29/58.

Nov. 24—Motion by resp. for extension of time to Dec. 15, 1958, to file brief. 11/25/58 Granted. Served 11/28/58. Dates of briefs of both parties extended as follows: Original briefs will be due 12/15/58. R/Briefs will be due 1/14/59.

Dec. 19—Motion by resp. for leave to file brief, brief lodged. Granted 12/22/58.

Dec. 22—Brief for Resp. filed. Served 12/29/58.

1959

Jan. 22—Motion by petitioner for extension of time to Feb. 15, 1959 to file Reply Brief. Granted Jan. 23, 1959.

Feb. 18—Reply Brief for Petr. filed. Served 2/19/59.

1960

Apr. 12—Findings of Fact and Opinion filed, Judge Harron. Decision will be entered for the Resp. Served 4/12/60.

Apr. 12—Decision entered, Judge Harron. Served 4/13/60.

May 26—Motion to fix amount of bond filed by petr.

May 26—Order fixing bond at \$10,000.00. Served 5/26/60.

June 17—Surety bond in the amount of \$10,000.00 approved and filed.

July 5—Petition for Review by U. S. Ct. of Ap. 9th Cir., with proof of service thereon, filed by petr.

July 5—Designation of contents of record on rev., with proof of service thereon, filed by petr.

July 8—Proof of service of pet. for rev. filed by petr.

[Title of Tax Court and Cause.]

PETITION TO REDETERMINE TAXES

The above named petitioner hereby petitions for a redetermination of the deficiencies set forth by the Commissioner of Internal Revenue in his notice of deficiency (Service symbols Ap:SF:AA:DEU 90-D; 1B), dated May 7, 1956, and as a basis of its proceeding alleges:

I. That petitioner is a corporation duly organized, existing and authorized to do business under the laws of the State of California; that its principal place of business is at 131-135 Hayes Street in the City and County of San Francisco, State of California. Taxes and returns for the years herein involved were paid and filed to and with Director, San Francisco, California.

II. The notice of deficiency (a copy of which is attached hereto and marked Exhibit "A") was mailed to petitioner on May 7, 1956.

III. The deficiencies as determined by the Commissioner are for income and excess profits taxes for the calendar years 1952, 1953 and 1954 in amounts as follows:

Year	Amount
1952	\$2,068.80
1953	\$2,574.30
1954	\$1,924.71
	<hr/>
	\$6,567.81

All of said amounts hereinabove set forth are in dispute, and are disputed by petitioner.

IV. The determination of petitioner's income (normal tax and surtax) and excess profits taxes for the calendar year 1952 set forth in said notice of deficiency is based upon the following errors:

1. The Commissioner erred in determining that there should be disallowed for the calendar year 1952 for the purpose of computing petitioner's income (normal tax and surtax) and excess profits taxes certain expenses in the sum of \$6,896.00 incurred and paid in that year (Item (a) page 2 of the Statement attached to Exhibit "A" hereto).

2. The Commissioner erred in determining that petitioner's normal tax and surtax net income for the calendar year 1952 was \$11,962.56 or any sum in excess of \$5066.56.

3. The Commissioner erred in determining that petitioner's income (normal tax and surtax) and excess profits taxes for the calendar year 1952 was \$3,588.77 or any sum in excess of \$1,519.97.

4. The Commissioner erred in determining that the payments in currency made by petitioner to various real estate brokers totalling \$6,896.00, \$8,581.00 and \$7,534.00 for the calendar years 1952, 1953 and 1954 respectively and charged to advertising expense are in fact rebates of escrow fees made in violation of California law and do not constitute an ordinary and necessary business expense. The Commissioner erred in determining that in the alternative these amounts constitute capital expenditures.

5. The Commissioner erred in determining that there is a deficiency in petitioner's income (normal

and surtax) and excess profits taxes for the calendar year 1952 of \$2,068.80 or any sum whatsoever.

6. Simply stated, the error complained of by petitioner for the calendar year 1952 is the disallowance of \$6,896.00 of business expenses as claimed on the return.

V. Petitioner in regard to its 1952 income and excess profits taxes concedes that the net income as disclosed by its return is \$5,066.50.

VI. The determination of petitioner's income and excess profits taxes for the calendar year 1953 set forth in said notice of deficiency is based upon the following errors:

1. The Commissioner erred in determining that there should be disallowed for the calendar year 1953 for the purpose of computing petitioner's income (normal tax and surtax) and excess profits taxes, certain expenses in the sum of \$8,581.00 (Item (a) page 3 of the Statement attached to said Exhibit "A" hereto).

2. The Commissioner erred in determining that petitioner's normal tax and surtax net income for the calendar year 1953 was \$12,864.59 or any sum in excess of \$4,283.59.

3. The Commissioner erred in determining that petitioner's income (normal tax and surtax) and excess profits taxes for the calendar year 1953 was \$3,859.38 or any sum in excess of \$1,285.08.

4. The Commissioner erred in determining that the payments in currency made by petitioner to various real estate brokers totalling \$6,896.00, \$8,581.00 and \$7,534.00 for the calendar years 1952, 1953 and

1954 respectively and charged to advertising expense are in fact rebates of escrow fees made in violation of California law and do not constitute an ordinary and necessary business expense. The Commissioner erred in determining that in the alternative these amounts constitute capital expenditures.

5. The Commissioner erred in determining that there is a deficiency in petitioner's income (normal tax and surtax) and excess profits taxes for the calendar year 1953 of \$2,574.30 or any sum whatsoever.

6. Simply stated, the error complained of by petitioner for the calendar year 1953 is the disallowance of \$8,581.00 of business expenses as claimed on the return.

VII. Petitioner in regard to its 1953 income and excess profits taxes concedes that the net income as disclosed by its return is \$4,283.59.

VIII. The determination of petitioner's income (normal tax and surtax) and excess profits taxes for the calendar year 1954 set forth in said notice of deficiency is based upon the following errors:

1. The Commissioner erred in determining that there should be disallowed for the calendar year 1954 for the purposes of computing petitioner's income (normal tax and surtax) and excess profits taxes certain expenses in the sum of \$7,534.00 incurred and paid in that year (Item (a) page 4 of the Statement attached as Exhibit "A").

2. The Commissioner erred in determining that petitioner's normal tax net income and surtax net income for the calendar year 1954 was \$6,415.71 or any sum in excess of a loss of \$1,118.29.

3. The Commissioner erred in determining that petitioner's income (normal tax and surtax) and excess profits taxes for the calendar year 1954 was \$1,924.71 or any sum whatsoever.

4. The Commissioner erred in determining that the payments in currency made by petitioner to various real estate brokers totaling \$6,896.00, \$8,581.00 and \$7,534.00 for the calendar years 1952, 1953 and 1954 respectively and charged to advertising expenses are in fact rebates of escrow fees made in violation of California law and do not constitute an ordinary and necessary business expense. The Commissioner erred in determining that in the alternative these amounts constitute capital expenditures.

5. The Commissioner erred in determining that there should be a disallowance of \$7,534.00 claimed on the return as advertising expenses.

6. The Commissioner erred in determining that there is a deficiency in petitioner's income (normal tax and surtax) and excess profits taxes for the calendar year 1954 of \$1,924.71 or any sum whatsoever.

7. Simply stated, the error complained of by petitioner for the calendar year 1954 is the disallowance of \$7,534.00 for business expenses as claimed on the return.

IX. Petitioner in respect to its 1954 income and excess profits taxes concedes that the net income as disclosed by its return is a loss of \$1,118.29.

X. The facts upon which petitioner relies as a basis of this proceeding are as follows:

1. Petitioner was incorporated in the State of California in July, 1946. Actual business was commenced in January of 1947. Its authorized capital is \$25,000.00. During the years 1947, 1948, 1949, 1950 and 1951, petitioner was building its title plant. All expenditures made for the acquisition of title information was capitalized during that period. In all, petitioner has a title plant with a capitalized cost of \$25,000.00, equal to its authorized capital. During this period of time petitioner expended \$25,000.00 in various ways—having tract maps prepared—purchasing tract maps—securing the tax assessor's title maps and other title information. At the conclusion of the above five year period, petitioner's title plant not only covered that five year period, but, because of the large expenditure of money, time and effort, the title plant went back a period of five years or more from 1947. Thus, petitioner's title plant on January 1, 1952, more than doubled the customary five year experience. Petitioner had also capitalized its title plant by twice the amount allowed with reference to its authorized capital. Petitioner's title plant was therefore complete long before January 1, 1952. The cost of reports and title insurance policies to petitioner is not a capital expense, but is an expense

incurred for the purchase of opinions of title which is similar to the expenses incurred for base searching and examination, and is therefore deductible in the year in which incurred and paid or accrued. The purchase of such reports by petitioner is a matter of business economy and efficiency, and actually decreases the cost of operation. The preliminary reports and policies of title insurance purchased by petitioner do not actually increase the value of the title plant of petitioner.

2. During the tax years 1952, 1953 and 1954, petitioner made expenditures in currency to real estate brokers to purchase, in some cases preliminary title reports issued by other companies, and in other cases to secure assignments of the actual title insurance issued by the other companies. Usually, the preliminary reports purchased did not relate to any transaction then being handled by petitioner for the real estate broker. However, in some cases the reports and/or insurance formed the basis upon which the title insurance was issued in a transaction being consummated at the time. All of such expenditures were in the nature of day to day maintenance of petitioner's title plant and were therefore ordinary and necessary expenses.

3. That the expenditure in the calendar year 1952 of \$6,896.00 for advertising was both reasonable, ordinary and necessary to the business carried on by petitioner.

4. That the expenditure in 1953 of \$8,581.00 for advertising was both reasonable, ordinary and necessary to the business carried on by petitioner.

5. That the expenditure in 1954 of \$7,534.00 for advertising was reasonable, ordinary and necessary to the business carried on by petitioner.

6. That the expenditures hereinbefore mentioned in the three paragraphs next preceding were incurred and paid for the purpose of upkeep and maintenance of petitioner's title plant.

Wherefore, petitioner prays that the court may hear this proceeding and determine that:

A. There should not be disallowed in determining petitioner's normal and surtax income for the year 1952 the sum of \$6,896.00 or any sum whatsoever.

B. Petitioner's normal and surtax net income for the calendar year 1952 was not \$11,962.56 or any sum in excess of \$5,066.36.

C. Petitioner's income (normal tax and surtax) and excess profits taxes for the calendar year 1952 was not \$3,588.77 or any sum in excess of \$1,519.97.

D. There was no deficiency in petitioner's income (normal and surtax) and excess profits taxes for the calendar year 1952 in the sum of \$2,068.80 or any sum whatsoever.

E. There should not be disallowed in determining petitioner's net income and surtax net income for the calendar year 1953 the sum of \$8,581 or any sum whatsoever.

F. Petitioner's normal and surtax net income for the calendar year 1953 was not \$12,864.59 or any sum in excess of \$4,283.59.

G. Petitioner's income (normal tax and surtax) and excess profits taxes for the calendar year 1953 was not \$3,859.38 or any sum in excess of \$1,285.08.

H. There was no deficiency in petitioner's income (normal tax and surtax) and excess profits taxes for the calendar year 1953 in the sum of \$2,574.30 or any sum whatsoever.

I. There should not be disallowed in computing petitioner's normal tax and surtax net income for the calendar year of 1954 the sum of \$7,534.00 or any sum whatsoever.

J. Petitioner's normal and surtax net income for the current year 1954 was not \$6,415.71 or any sum in excess of a loss of \$1,118.29.

K. Petitioner's income (normal tax and surtax) and excess profits taxes for the calendar year 1954 was not \$1,924.71 or any sum whatsoever.

L. There was no deficiency in petitioner's income (normal tax and surtax) and excess profits taxes for the calendar year 1954 in the sum of \$1,924.71 or any sum whatsoever.

M. And for such other and further relief as may be proper.

/s/ JOSEPH S. ROGERS,

/s/ KENNETH S. CAREY,

Attorneys for Petitioner.

Affidavit

State of California,
City and County of San Francisco—ss.

J. M. Rolls, being first duly sworn, deposes and says:

That he is an officer, to wit, the President of Bay Counties Title Guaranty Company, a corporation, and for that reason makes this affidavit on its behalf and has the authority to act for said corporation; that he has read the foregoing petition and is familiar with the statements contained therein and that the statements contained therein are true of his own knowledge except as to matters therein stated upon information or belief, and that as to those matters he believes it to be true.

/s/ J. M. ROLLS.

Subscribed and sworn to before me this 27th day of July, 1956.

[Seal] /s/ RUTH M. PARRIS,

Notary Public in and for the City and County of San Francisco, State of California. My Commission expires: 5th November, 1956.

EXHIBIT "A"

Appellate Division—San Francisco Region
Room 1010—870 Market Street
San Francisco 2, California

Ap:SF:AA:DRU

90-D:IB

May 7, 1956

Bay Counties Title Guaranty Company
(formerly Bay Counties Escrow Company)
131-135 Hayes Street
San Francisco, California

Gentlemen:

You are advised that the determination of your income tax liability for the taxable year(s) ended December 31, 1952 to December 31, 1954, inclusive, discloses a deficiency or deficiencies of \$6,567.81 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia in which event that day is not counted as the 90th

Exhibit "A"—(Continued)

day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Assistant Regional Commissioner, Appellate, Rm. 1010, 870 Market St., San Francisco 2, California. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is the earlier.

Very truly yours,

RUSSELL C. HARRINGTON

Commissioner,

By

Special Assistant

Appellate Division

Enclosures:

Statement

Agreement Form

IRS Form 160

Exhibit "A"—(Continued)

Ap:SF:AA:DRU

90-D:IB

STATEMENT

Bay Counties Title Guaranty Company (formerly Bay Counties Escrow Company) 131-135 Hayes Street, San Francisco, California

Tax Liability for the Taxable Years Ended December 31, 1952
to December 31, 1954, Inclusive.

Year		Liability	Assessed	Deficiency
1952	Income Tax	\$3,588.77	\$1,519.97	\$2,068.80
1953	Income Tax	3,859.38	1,285.08	2,574.30
1954	Income Tax	1,924.71	None	1,924.71
Totals		<u>\$9,372.86</u>	<u>\$2,805.05</u>	<u>\$6,567.81</u>

In making this determination of your income tax liability, careful consideration has been given to your protest dated December 29, 1955 and to the statement made at the conferences held on March 7, March 14 and April 17, 1956.

A copy of this letter and statement has been mailed to your representatives, Messrs. Joseph D. Rogers and Kenneth Carey, 111 Sutter Street, San Francisco, California, in accordance with the authority contained in the power of attorney executed by you.

Adjustments to Income

Year: 1952

Net income as disclosed by return	\$ 5,066.56
Unallowable deductions and additional income:	
(a) Advertising expense	6,896.00
Net income as adjusted	<u>\$11,962.56</u>

Explanation of Adjustments

(a) It is held that the payments in currency made by you to various real estate brokers totaling \$6,896.00, \$8,581.00 and \$7,534.00 for the calendar years 1952, 1953 and 1954 respectively and charged to advertising expense are in fact rebates of escrow fees made in violation of California law and do not constitute an ordinary and necessary business expense.

In the alternative these amounts constitute capital expenditures.

Exhibit "A"—(Continued)

Computation of Income Tax

Year: 1952

Net income	\$11,962.56
Surtax net income	11,962.56
Combined normal tax and surtax at 30%	3,588.77
Total income and excess profits tax liability	3,588.77
Income and excess profits tax assessed Account No. CI 10456, San Francisco, California	1,519.97

Deficiency in income and excess profits tax 2,068.80

Adjustments to Income

Year: 1953

Net income as disclosed by return	\$ 4,283.59
Unallowable deductions and additional income:	
(a) Advertising expense	8,581.00
Net income as adjusted	\$12,864.59

Explanation of Adjustments

(a) The amount of \$8,581.00 claimed on the return as advertising expense is disallowed as explained in Explanation of Adjustments in the year 1952.

Computation of Income Tax

Year: 1953

Net income	\$12,864.59
Surtax net income	\$12,864.59
Combined normal tax and surtax at 30%	\$ 3,859.38
Total income and excess profits tax liability	\$ 3,859.38
Income and excess profits tax assessed Account No. CI 200184, San Francisco, California	1,285.08

Deficiency in income and excess profits tax\$ 2,574.30

Adjustments to Income

Year: 1954

Net income as disclosed by return (loss)	\$(1,118.29)
Unallowable deductions and additional income:	
(a) Advertising expense	7,534.00
Net income as adjusted	\$ 6,415.71

Exhibit "A"—(Continued)

Explanation of Adjustments

(a) The amount of \$7,534.00 claimed on the return as advertising expense is disallowed as explained in Explanation of Adjustments in the year 1952.

Computation of Income Tax

Year: 1954

Net Income	\$6,415.71
Surtax net income	\$6,415.71
Combined normal tax and surtax at 30%	\$1,924.71
Total income and excess profits tax liability.....	\$1,924.71
Income and excess profits tax assessed Account No.	
CN 200063, San Francisco, California	None
<hr/>	
Deficiency in income and excess profits tax	\$1,924.71
Agreement Form	
IRS Form 160	

[Endorsed]: T.C.U.S. Filed August 2, 1956.

[Title of Tax Court and Cause.]

ANSWER

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, John Potts Barnes, Chief Counsel, Internal Revenue Service, and for answer to the petition filed by the above-named petitioner admits and denies as follows:

I, II, III. Admits the allegations in paragraphs I, II and III.

IV-1 to 6, inclusive. Denies the allegations of error in subparagraphs 1 to 6, inclusive, of paragraph IV.

V. Admits the allegations in paragraph V.

VI-1 to 6, inclusive. Denies the allegations of error in subparagraphs 1 to 6, inclusive, of paragraph VI.

VII. Admits the allegations in paragraph VII.

VIII-1 to 7, inclusive. Denies the allegations of error in subparagraphs 1 to 7, inclusive, of paragraph VIII.

IX. Admits the allegations in paragraph IX.

X-1 to 6, inclusive. Denies the allegations in subparagraphs 1 to 6, inclusive, of paragraph X.

XI. Denies generally and specifically each and every allegation in the petition not hereinbefore admitted, qualified or denied.

Wherefore, it is prayed that the Commissioner's determination be approved and the petitioner's appeal denied.

/s/ JOHN POTTS BARNES, J.,
Chief Counsel,
Internal Revenue Service.

Of Counsel: Melvin L. Sears, Regional Counsel;
T. M. Mather, Assistant Regional Counsel, Edward H. Boyle, Special Attorney, Internal Revenue Service, 1067 Flood Building, San Francisco, California.

[Endorsed]: T.C.U.S. Filed September 11, 1956.

[Title of Tax Court and Cause.]

STIPULATION OF FACTS

It Is Hereby Stipulated and Agreed between the Commissioner of Internal Revenue and the above entitled taxpayer, by their respective undersigned attorneys, that the following facts shall be taken as true, provided, however, that this stipulation does not waive the right of either party to introduce other evidence not at variance with the facts herein stipulated, or to object to the introduction in evidence of any such facts on the grounds of immateriality or irrelevancy:

1. That petitioner is a corporation duly organized, existing and authorized to do business under the laws of the State of California; that its principal place of business is at 131-135 Hayes Street in the City and County of San Francisco, State of California. Taxes and returns for the years herein involved were paid to and filed with Director of Internal Revenue, San Francisco, California.

2. The petitioner is not a title insurer but is an underwritten title company as defined in Section 12402 of the Insurance Code of California. Such insurance policies as are required are underwritten by Pacific Coast Title Insurance Company of Los Angeles, California, and co-insured by Louisville Title Insurance Company of Louisville, Kentucky.

3. Petitioner's income tax returns for 1952, 1953 and 1954 were filed with the Director of Internal Revenue, San Francisco.

4. The notice of deficiency (a copy of which is attached to the petition and marked Exhibit "A") was mailed to petitioner on May 7, 1956.

5. The deficiencies as determined by the Commissioner are for income and excess profits taxes for the calendar years 1952, 1953 and 1954, in amounts as follows:

Year	Amount
1952	\$2,068.80
1953	2,574.30
1954	1,924.71
	<hr/>
	\$6,567.81

All of said amounts hereinabove set forth are in dispute, and are disputed by petitioner.

6. That the net or taxable income disclosed by petitioner's 1952 tax return was \$5,066.56.

7. That in the calendar year 1952, petitioner expended \$6,896.00 in currency to real estate brokers.

8. That the net or taxable income shown by petitioner's 1953 tax return was \$4,283.59.

9. That in the calendar year 1953 petitioner expended \$8,581.00 in currency to real estate brokers.

10. That the net or taxable income shown in petitioner's 1954 tax return was a net loss of \$1,118.29.

11. That in the calendar year 1954, petitioner expended \$7,534.00 in currency to real estate brokers.

12. Petitioner was incorporated in the State of California on July 3, 1946. A copy of the Articles of Incorporation is attached hereto as Exhibit "1-A".

/s/ JOSEPH S. ROGERS,
/s/ KENNETH S. CAREY,
Counsel for Petitioner.

/s/ ARCH M. CANTRALL, E.H.B.,
Chief Counsel,
Internal Revenue Service,
Counsel for Respondent.

[Endorsed]: T.C.U.S. Filed October 8, 1958.

34 T. C. No. 3

Tax Court of the United States

Bay Counties Title Guaranty Company, Petitioner,
v. Commissioner of Internal Revenue, Respondent.

Docket No. 63623

Filed April 12, 1960.

FINDINGS OF FACT AND OPINION

Petitioner is an underwritten title and controlled escrow company engaged in the business of making abstracts of titles. It had an established title plant prior to 1952 which was its chief capital asset. Since petitioner started business it has followed the

practice of acquiring for a consideration from others each year a substantial number of previously prepared title reports showing the status of titles to pieces of property up to some date prior to petitioner's purchase. Most of such title reports were filed in petitioner's records for use in subsequent years depending on when the petitioner might receive business requiring its preparation of up-to-date abstracts on the same pieces of property in connection with new transactions. Prior to 1952 petitioner charged the cost of such reports to the capital account for its title plant, but in 1952 it charged the same expense to current operating expenses and deducted it as ordinary and necessary business expense. The same practice was followed in 1953 and 1954. Held: The purchased title reports represented additions to and betterments of petitioner's title plant; their useful life extended beyond the year of purchase; and the expenditure was a nondeductible capital expense.

Kenneth S. Carey, Esq., and Joseph S. Rogers, Esq., for the petitioner.

Edward H. Boyle, Esq., and Joseph D. Holmes, Jr., Esq., for the respondent.

The Commissioner determined deficiencies in income tax for the taxable years 1952, 1953, and 1954 in the amounts of \$2,068.80, \$2,574.30, and \$1,924.71, respectively. The issue is whether expenditures in each year which allegedly were made for copies of preliminary reports on pieces of real estate constitute ordinary and necessary expenses of carrying on petitioner's business under section 23(a)(1)(A),

1939 Code, and section 162, 1954 Code, or are non-deductible capital expenditures.

Findings of Fact

The petitioner is a California corporation which was incorporated on July 3, 1946, and entered into business operations in September 1946. Its office is in San Francisco, California. It filed its returns with the collector of internal revenue for the first district of California. Petitioner keeps its books and reports income on an accrual basis. However, the expenditures in question were cash disbursements.

The petitioner is an underwritten title company, as defined in section 12402 of the California Insurance Code, and escrow company. Petitioner is an agent of the Pacific Coast Title Insurance Company of Los Angeles, hereinafter called Pacific Title, which began business in 1944 and has nine other agents.

Pacific Title is engaged in the title insurance business. It is an underwriting company which issues policies of title insurance insuring titles to real property. Its co-insurer is the Louisville Title Insurance Company of Louisville, Kentucky. The president of the petitioner, J. M. Rolls, is an assistant secretary of Pacific Title.

The petitioner conducts examinations and searches of titles and then requests Pacific Title to issue policies of title insurance based upon its title examination. The petitioner sells title insurance policies of Pacific Title.

The petitioner, as agent of Pacific Title, has an exclusive agency in San Francisco County which includes the city of San Francisco. The records for title examination and search are in the offices of the petitioner.

The petitioner is also an escrow company. The closings of transactions involving transfers of real estate are held in its offices. Petitioner receives escrow fees for its services which are paid by the purchasers of real estate. A great deal of petitioner's business is referred by real estate brokers. Petitioner also handles accommodation and other escrows and it receives income from such general services in addition to fees for the closing of real estate transactions.

As of December 31, 1951, petitioner had an established and a typical title plant. The term "plant" is used by title companies to describe collectively the complex of the records which it owns and uses in making searches of titles and preparing abstracts of titles to all of the real estate within the area of a company's operations. Petitioner's title plant included books of maps of all of the real estate, by parcels and lots, in San Francisco County; the lot books covering every lot in the county; books of abstracts of recorded instruments; a set of general indices; the tax assessor's ownership records back to 1938; a complete set of Edwards Abstracts going back to 1908, which contains daily reports of all recordings affecting titles to and interests in real estate such as transfers, bankruptcies, probate records, and litigation; and an accumulation of peti-

tioner's records of searches, abstracts, documents, opinions, and miscellaneous data. Petitioner's title plant was acquired and accumulated during the 5 years 1947-1951. A typical title plant is augmented in the course of time.

In carrying on its business, petitioner uses its own basic records and, in addition, the city and county recorder's office records, and other customary sources of relevant records. In its own plant, information is segregated as to pieces of property in connection with which a code system is used.

For all practical purposes, as of the end of 1951, petitioner's title plant contained records of every piece of property in San Francisco County for which records existed. Also, its records in its plant showed every recorded transaction affecting real property in the county for a period in excess of 5 years. The set of Edwards Abstracts provides information back to 1908. Because of the destruction of records in 1906 during the San Francisco fire, property records for the city and county of San Francisco were reestablished after 1906.

Petitioner's capital consists of \$25,000 represented by common stock. Its authorized stock is 2,500 shares having a total par value of \$25,000.

At the end of 1951, the book value of petitioner's title plant was \$25,000.

Prior to 1952, the petitioner charged to capital, i.e., capitalized, all of its expenditures for real estate records of every kind including those for its basic title records plant. By the end of 1951, the total cost of petitioner's plant amounted to \$25,000.

When petitioner began its business in 1946, it had 4 employees. In 1952, it had 34 employees including 13 searchers and 2 examiners, and 3 in the general indices section. The work of a searcher is to search and assemble material relating to titles; the examiner writes an abstract report and opinion about titles.

In general, in order to collect the information required before a policy of title insurance will be issued, it is necessary to make a complete search of the records of ownership of a piece of property (the chain of title) over a period of years, to search for interests in and encumbrances on a title, and to examine all records affecting title so as to determine whether a buyer will obtain a clear title, and so as to guarantee a title or the correctness of information with respect thereto. A factual determination of title must be made and of the conditions and limitations attaching to the title to property.

There are no statutory requirements relating to the method or means by which those engaged in making title searches, examinations, and abstracts of title for use by title insurers shall secure information. Although it is customary for title companies to cause to be made independent searches, it is also common for their examiners to make use of previously prepared, or old, title reports and preliminary title reports as a starter, and to search the period after the end-date of such reports to bring the search up to the date required. The practice of using existing preliminary reports on titles

and existing title insurance policies is generally followed. Such practice eliminates the procedure of abstracting the title to a piece of property back to the first record. If there is a starter report of title to a particular piece of property, it is generally considered unnecessary to make a complete search back to the earliest records. But if a starter report is not available, a complete search must be made. Frequently a starter report, or a previously prepared policy of title insurance, provides a title record up to within a few years of the date of the examination which is to be made.

In the title company business a preliminary report and a starter report mean the same thing. A title examiner seldom retraces the search covered by a starter report or a previously prepared title policy; he does not go behind the starter report. Time and expense are saved where starter reports on a piece of property are used in examining the title to a piece of property.

In San Francisco there are four old and well-established title companies which issue policies of title insurance, the California Pacific Title Company, Western Title Insurance and Guaranty Company, Northern Counties Title Insurance Company, and City Title Insurance Company. Among them, there is an understanding and arrangement for the reciprocal exchange of information about real estate titles which each has in its files. Thus, one concern making a search of title to a piece of real estate with respect to which another previously has made

an examination may make use of the existing report made by the other concern, as a starter.

The petitioner is not admitted to participation in the reciprocal exchange arrangements of the four above-named title companies. The petitioner and Pacific Title compete with the above companies.

Some title companies purchase copies of preliminary, starter reports and of old title policies from various sources, such as real estate brokers, escrow companies, and lending institutions, and in California this is a common practice. There is no statutory reason why a title insurance company or an abstract company may not purchase a copy of an old title insurance policy or preliminary report on a specific property and issue a new policy of title insurance relying in whole or in part upon information contained in the former policy.

Petitioner has followed the practice since it began business of obtaining copies of preliminary, starter reports and of old title policies from real estate concerns, real estate brokers, lending institutions, and others. It followed that practice before and during the taxable years. It has made payments for them or sometimes it has obtained them free of charge.

It is routine for a real estate broker who is handling a proposed transaction for the sale of a piece of real estate to obtain an up-to-date preliminary report on the particular property involved. Such preliminary report shows the owner of record, the

tax status of the property, liens and encumbrances, if any, existing restrictions, and obligations of the record owner. Such preliminary title report is obtained from the title company from which it is anticipated the completed title insurance policy will be purchased when the sale is closed. No charge is made for the preliminary report by the title company since the full charge will be made for the title policy. The title policy will be the complete and current coverage. In connection with a proposed sale of a piece of property, the real estate broker often is asked by the title company with which he is dealing in respect to the contemplated sale if he can furnish a previous title policy, or a copy. If the real estate broker can furnish a previous policy, he may obtain the requested preliminary report of the title company sooner.

Before and after 1951, several real estate brokers in the San Francisco area have frequently furnished the petitioner with copies, from their files, of preliminary reports and of title policies on various pieces of real estate involved in transactions which they have handled in the past and in which transactions the petitioner did not participate, for which they have received cash payments from the petitioner. Often copies of such reports or old title policies on a particular piece of property have been furnished upon requests of petitioner, and at times petitioner has made use of them in its current search on a particular property. At other times, petitioner has put copies of preliminary re-

ports or of old title policies in its files to serve as a starter in a future search.

In most instances, real estate brokers do not charge any stated fee or exact amount for furnishing a copy of a preliminary report or old title policy to the petitioner, and petitioner has followed the practice of making payments periodically to real estate brokers of some amounts which it determined. Such payments, at times, have been made monthly and they have been in varying amounts ranging from \$25, \$60, \$90, \$100, or more.

In 1952, as an example, petitioner had an arrangement with one real estate firm in San Francisco whereby it could look through its files and locate copies of preliminary reports or old title policies which it wanted to use and obtain them at no cost. In another instance, a real estate broker having his own business regularly provided petitioner with copies of preliminary reports or old title policies from his files and he periodically received lump sum payments from petitioner for such general accommodation but not for individual copies of report or policies. Such payments always were made in cash.

During the taxable years, petitioner made cash payments to real estate brokers in the total amounts set forth below:

Year	Amount
1952	\$6,896
1953	8,581
1954	7,534

The following schedule shows the amounts of such cash payments by months:

Month	1952	1953	1954
January	\$ 386	\$ 736	\$ - 0 -
February	505	521	556
March	484	532	467
April	482	729	812
May	503	651	470
June	575	644	480
July	579	687	645
August	671	715	674
September	530	778	589
October	661	704	693
November	804	768	700
December	716	1,116	1,448
	<hr/>	<hr/>	<hr/>
	\$ 6,896	\$ 8,581	\$ 7,534

The names of the real estate brokers and the payments received by them in 1952, 1953, and 1954 were not reflected in the books and records of petitioner, but were in a personal record belonging to petitioner's president, Rolls. The payments to the real estate brokers were made by Rolls personally in cash. Checks of the petitioner were made payable to cash and cash was made available in this way to make payments to real estate brokers. The account-

ing records showed the cash withdrawals, and the amounts of the payments to real estate brokers were charged on the books to an expense account such as advertising expense.

In petitioner's returns for the taxable year 1952-1954, inclusive, the total amounts paid to brokers, stated above, were included in the entire amount deducted in each year for advertising expense, or some other operating expense.

There have been many instances where real estate brokers have placed business with the petitioner and the petitioner has not purchased any title reports or copies of old title policies from them.

Rolls kept a personal record, apart from the accounting record of the petitioner, of the payments made to brokers which he describes as his personal, broker account record. He maintained those records. They show the volume of business received from various real estate brokers. In these records Rolls made note of the amounts of payments which he made to real estate brokers, and he also entered the amounts involved in transactions handled by the petitioner which were closed by the individual brokers. However, this particular record does not show what preliminary reports and copies of title policies on particular pieces of real estate might have been received by the petitioner from any individual real estate broker.

Neither the petitioner nor its president, Rolls, maintained any record at any time, including the taxable years, showing the specific preliminary title reports or copies of old title policies on particular

pieces of real estate which the petitioner had purchased during a year from any real estate broker or any other source. Of course, reference to such individual preliminary title reports and copies of old title policies might indicate to whom or for whom the reports were made and, therefore, an inference might be drawn with respect to the concerns or persons from whom the petitioner acquired such reports and title policies. Petitioner did not keep a record of how many preliminary reports or old title policies on various pieces of real estate it had purchased in each of the taxable years.

The petitioner's system for filing the copies of preliminary title reports and old title policies on various pieces of property is as follows: Petitioner's office records are maintained on the basis of the assessor's lot and block system. The number of a lot and its location in a block is entered in the upper right-hand corner of a copy of a preliminary title report or old title policy. Such numbers serve to relate such documents to the petitioner's index of properties in its title plant. On the individual cards in petitioner's card system, which serves as an index to records on individual pieces of property in the county of San Francisco, a red letter "S" is placed to show that petitioner has a preliminary title report or a copy of an old title policy relating to a piece of property. Through such index system, the petitioner is able to determine whether or not it has a preliminary title report on a piece of property which can be used as a starter when

and if it makes a title search and abstract on the property.

During the years 1952-1954, petitioner acquired many preliminary title reports or copies of old title policies; it paid for some of these documents; and it filed them in its plant records. The bulk of the preliminary title reports and title policies which petitioner purchased during the taxable years did not relate to any searches and examinations of titles which it made in the taxable years for the issuance of title insurance policies. Therefore, such documents were filed for such future use, if any, as might develop.

Prior to 1952, petitioner capitalized in its accounting records all payments for preliminary title reports and all old title policies. Petitioner, for the first time, in 1952, 1953, and 1954 charged all payments for such preliminary title reports and old title policies to current operating expenses and took deductions therefor in its income tax returns. The respondent disallowed the entire amounts of the deductions, \$6,896 in 1952, \$8,581 in 1953, and \$7,534 in 1954.

The preliminary title reports and old title policies purchased by the petitioner in each taxable year had a useful life beyond the year of purchase which extended until such years as petitioner might make use of them in its own up-to-date title abstracts relating to the same pieces of property in connection with future transactions dealing with them. The future time of use in petitioner's business was problematic and indefinite depending upon

when, as, and if the petitioner might be called upon to make abstracts of title to the same pieces of property. The old preliminary title reports and old title policies constituted additions and betterments to petitioner's title plant, and the expenditure for them was a nondeductible capital expense. The expenditures were not current maintenance expenses within the category of ordinary and necessary business expenses.

Opinion

Harron, Judge: The issue relates to the matter of the proper treatment for tax purposes of an expense which petitioner incurs and pays in cash each year to real estate brokers, chiefly, for preliminary title reports and copies of not-current title insurance policies which have been prepared and used previously by others in the same business. For convenience such material is described hereinafter, collectively, as starter reports.

It is understood that for the most part each of the starter reports acquired deals with the status of the title to an individual and different piece of real estate up to a date which is prior to the time of petitioner's purchase, although petitioner concedes that there are instances of purchasing more than one report which relates to the same piece of property, in which event there is some duplication of starter reports which are purchased.

It is understood, further, that the petitioner makes no effort to ascribe a purchase price to each

individual starter report which it acquires; that sellers of such reports do not fix a price for each report sold to petitioner; that petitioner pays a lump sum periodically (usually monthly) for several reports; and that during a year an undisclosed number of starter reports are purchased. Thus, for example, the record does not show how many reports petitioner purchased in 1952 for \$6,896, or in 1953 for \$8,581, or in 1954 for \$7,534.

It is understood, also, that the petitioner concedes that "the bulk" or most of the reports which it purchases in a year are not, during the same year as the expense is incurred and paid, made use of in the searches, examinations, and writing of abstracts of title on individual pieces of real estate, but, rather, are filed away in petitioner's files of records for future use, if, as, and when petitioner should write abstracts of the title to any of the properties covered by such starter reports.

It is noted at the outset, in addition, that the record does not show anything about the fees, or rates of charges, which petitioner receives for a title abstract, or what elements enter into its costs of making the search, the examination, and finally writing a title abstract. For example, the petitioner does not contend, where it makes use of one of the purchased starter reports on the title to a piece of property in its search and writing of a title abstract which is brought up to the date of the closing of a real estate transaction, that it includes

in its charge for its completed abstract any amount as its cost of the purchased starter report.

The facts have been set forth fully in the Findings of Fact and with the foregoing summary of certain relevant factors, the circumstances within which the issue to be decided arises is, we think, clear.

The primary question is whether the total amount of expense paid in each taxable year is a non-deductible capital expense under section 24(a)(2), or ordinary and necessary business expense deductible under section 23(a)(1)(A). For convenience, reference is made to the applicable sections of the 1939 Code. The corresponding provisions of the 1954 Code are substantially the same.

In substance, it is the petitioner's view that the expense of purchasing starter reports which, for the most part, are held in expectation of future use, is comparable to the expense of maintaining its title plant, a capital asset, in good and efficient working condition. Having such starter reports on hand, argues the petitioner, later saves time and expense in writing a particular title abstract. Such alleged maintenance expense is claimed by the petitioner to be of the same nature as ordinary maintenance expenditures which do not benefit future periods and are, therefore, properly charged to operations in the year the expenses are incurred and paid, and are deductible as ordinary and necessary expenses of petitioner's business. The petitioner does not cite any case specifically dealing

with the issue to be decided. However, petitioner relies largely upon the respondent's O.D. 1018 (1921), 5 C.B. 119, set forth in the margin.¹

Whether a given expense is an ordinary and necessary business expense deductible from gross income in the year of payment under section 23(a) (1)(A), or whether it constitutes an amount paid for an asset, or an addition to assets, or a betterment which increases the value of assets so as to be not deductible under section 24(a)(2) is a question of fact. *Russell Box Co. v. Commissioner*, 208 F. 2d 452, 454. It is often a difficult matter to draw the line between a capital outlay and one for current maintenance. *Hotel Kingkade v. Commissioner*, 180 F. 2d 310, 312. It is helpful to bear in mind, nevertheless, the basic distinction between an

¹ O.D. 1018 is as follows:

Title abstract companies incur relatively large and continuous expenditures in keeping their plants up to date, such as the expense of adding and incorporating in the plant records that are being made daily in the various courts and in the Recorder's office.

These records which are added to and incorporated in the plant for the purpose of keeping it in up to date running order and preventing depreciation are in the nature of ordinary and necessary repairs. The expenses, therefore, incurred in making such records are current expenses, and as such are deductible for the years in which incurred and paid or accrued.

Since a title plant is not an asset of a nature which gradually approaches a point where its usefulness is exhausted, but is an asset of a more or less permanent character, it is not a proper subject of a depreciation allowance.

ordinary and necessary business expense and a capital expenditure. In this connection, the following statement of the fundamental distinction, stated in Kester, *Principles of Accounting*, p. 130, is helpful:

Asset and Expense Expenditures.—At the time of organization of a business, the capital contributed by the owner is expended to acquire the necessary assets with which to carry on the business. A fundamental distinction must be made between expenditures for the purchase and installation of the assets themselves and expenditures for expenses in connection with their repair, maintenance, and upkeep.

An asset account is chargeable with all costs incurred up to the point of putting the asset in shape for use in the business. It may be charged also with subsequent expenditures resulting in an increase in its value. Such increase is frequently termed a betterment. Expenditures, however, which are for the purpose of repairs or of keeping the property from too rapid depreciation without adding anything to its original value, must be charged to a properly labeled expense account. These expenditures for expenses, such as repairs, maintenance, upkeep, together with depreciation, are subtractions from profit and proprietorship, while asset expenditures usually constitute an exchange of the asset cash for some other asset, which exchange has no effect on proprietorship.

These expenditures are frequently distinguished as capital and revenue expenditures.

After fully considering the complete record and petitioner's contentions and arguments, it is concluded that total expense of purchasing starter reports in each of the taxable years, incurred and paid in each year, is a nondeductible capital expense which properly is to be charged to petitioner's asset account for its title plant as an expenditure which increases the title plant's value and is for betterment thereof, in general. Upon all of the facts and under all of the circumstances, it cannot be found and held that the respondent erred in disallowing the claimed deduction in each year.

Petitioner contends, and it may be conceded, that as of the end of 1951 it had an established title plant, the cost of which had been capitalized. Petitioner agrees that the records which constitute a title plant are capital assets, as is now well established. See *The Record Abstract Co.*, 2 B.T.A. 628, 631-632; *Cuyahoga Abstract Title & Trust Co.*, 7 B.T.A. 95, 98-99, *affd.* 29 F. 2d 448, *certiorari denied* 279 U.S. 848; *Crooks v. Kansas City Title & Trust Co.*, 46 F. 2d 928. Petitioner, however, is in error in its contention that since it had a title plant, the expense of purchasing previously prepared starter reports for title abstracts necessarily is a maintenance and, therefore, current operating expense.

It is admitted that the value of the starter reports extends beyond the year of purchase and continues until such time in some indeterminate future year as petitioner shall have the occasion to write an abstract on a title covered up to a point

by a starter report. The time of future use may be many years later. We think it is clear beyond any doubt that the starter reports have an economic life extended beyond the year of purchase and that they represented additions and supplements to the plant which increased its value. It is a generally accepted rule that an amount expended for an asset having a useful life which is not consumed in the year of the expenditure is usually to be classified as a capital item. First National Bank of St. Louis, 3 B.T.A. 807; W. B. Harbeson Lumber Co., 24 B.T.A. 542.

Petitioner's reliance upon respondent's O.D. 1018 is misplaced. First, it must be observed that an Office Decision of the Commissioner lacks the status of a regulation and ordinarily must be regarded as having limited weight circumscribed by its particular facts. O.D. 1018 refers to the expense of obtaining "records that are being made daily in various courts and in the Recorder's office" which title abstract companies continuously incur. Petitioner incurs the kind of expense described in the cited ruling by its continuous subscription to Edwards Abstracts which furnishes such daily records of the courts and the Recorder's office in San Francisco County. The expense under consideration here of purchasing starter reports is not the same and is distinguishable from the kind of expense described in the ruling. A starter report covers a search and examination of title and while it does not have the coverage of a completed abstract, it is

within the same general category. O.D. 1018 does not refer to reports on title.

The petitioner advances another argument which deals with the limitation contained in section 12372 of the California Insurance Code on a title insurer's valuation on its plant as an asset. Petitioner contends that since one of the provisions of that statutory provision limits the valuation of its title plant to actual cost, not to exceed 50 per cent of the total par value of its outstanding capital stock, it could not, after 1951, add to the then cost of its plant the amount expended in each year for starter reports. This contention has no relevance here and is without merit. Section 12372 of the Insurance Code deals *inter alia* with an insurer's financial statement. It provides, also, in subsections (b) and (c) that an insurer may, in its statement, treat its plant as an asset having a lesser value than 50 per cent of the par value of outstanding stock, as allowed in (a); or it may omit entirely from the statement such asset. In any event, the cited provision of the California Insurance Code does not in any respect bear upon, relate to, or control the question here which arises under the Federal Internal Revenue Codes.

Cases cited by the petitioner have been considered but they are distinguishable. Consolidated Apparel Co., 17 T.C. 1570, affirmed and reversed in part on other grounds, 207 F. 2d 580, is distinguishable from this case in that the expense there, advertising expense, was clearly an item which properly can be expensed.

1953, and 1954 in the amounts of \$2,068.80, \$2,574.30, and \$1,924.71, respectively.

[Seal] /s/ MARION J. HARRON,
Judge.

Entered April 12, 1960.

Served April 13, 1960.

In the United States Court of Appeals
For the Ninth Circuit

T. C. Docket No. 63623

BAY COUNTIES TITLE GUARANTY COM-
PANY (formerly BAY COUNTIES ES-
CROW COMPANY), Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR REVIEW BY THE UNITED
STATES COURT OF APPEALS FOR THE
NINTH CIRCUIT

Now Comes the above named petitioner by its attorneys, Peart, Baraty and Hassard and Kenneth S. Carey, and petitions the United States Court of Appeals for the Ninth Circuit to review the opinion of the Tax Court of the United States rendered

and entered on April 12, 1960 ordering and deciding that there are deficiencies in petitioner's federal income taxes for the calendar years 1952, 1953 and 1954 of \$2,068.80, \$2,574.30 and \$1,924.71 respectively.

I.

This petition for review is filed pursuant to the provisions of Sections 7482 and 7483 of the Internal Revenue Code of 1954.

The petitioner is Bay Counties Title Guaranty Company, a California corporation.

Said petitioner filed its federal income tax returns for the calendar years in question with the District Director of Internal Revenue, San Francisco, California. Jurisdiction is vested in the United States Court of Appeals for the Ninth Circuit pursuant to Section 7482(b)(1) of the Internal Revenue Code of 1954.

II.

Nature of the Controversy:

The controversy involves the proper determination of petitioner's federal income taxes for the calendar years 1952, 1953 and 1954. During the years 1952-1954 petitioner purchased many preliminary title reports or copies of title insurance poli-

cies. In 1952 petitioner paid \$6,896.00 for such reports or policies, in 1953 \$8,581.00 and in 1954 \$7,534.00. Each report or policy was immediately filed and incorporated in petitioner's plant in much the same manner as any other item of information relating to title. Petitioner claimed the sums expended in the years in question as ordinary and necessary expenses of doing business. The Commissioner disallowed such deductions on the ground that they were capital expenditures. The Tax Court sustained the Commissioner on this contention.

III.

Taxpayer being aggrieved by the findings of fact and conclusions of law contained in said findings and opinion of the Tax Court and by its decision entered pursuant thereto, desires to obtain a review thereof by the United States Court of Appeals, Ninth Circuit.

IV.

Petitioner assigns as errors the following findings and conclusions of the Tax Court of the United States:

(a) That the preliminary title reports and old title policies purchased by the petitioner in each taxable year had a useful life beyond the year of purchase which extended until such years as peti-

tioner might make use of them in its own up-to-date title abstracts relating to the same pieces of property in connection with future transactions dealing with them.

(b) That the future time of use in petitioner's business was problematic and indefinite depending upon when, as, and if the petitioner might be called upon to make abstracts of title to the same pieces of property.

(c) That the old preliminary title reports and old title policies constituted additions and betterments to petitioner's title plant, and the expenditure for them was a non-deductible capital expense.

(d) That the expenditures were not current maintenance expenses within the category of ordinary and necessary business expenses.

Dated: June 30, 1960.

PEART, BARATY & HASSARD,

/s/ By JOSEPH S. ROGERS,

/s/ KENNETH S. CAREY,

Attorneys for Petitioner.

Affidavit of Service by Mail Attached.

[Endorsed]: T.C.U.S. Filed July 5, 1960.

[Title of Tax Court and Cause.]

CERTIFICATE

I, Howard P. Locke, Clerk of the Tax Court of the United States, do hereby certify that the documents submitted under this certificate, 1 to 29, inclusive, as called for by the designation, are the original documents of record on file in my office (excepting the original exhibits which are separately certified), and a true copy of the docket entries as they appear in the official docket of my office, in the case docketed at the above number in which the petitioner in this Court has filed a petition for review.

In testimony whereof, I hereunto set my hand and affix the seal of the Tax Court of the United States, at Washington, in the District of Columbia, this 3rd day of August, 1960.

[Seal] /s/ HOWARD P. LOCKE,
Clerk of the Court.

The Clerk: Docket No. 63623, Bay Counties Title Guaranty Company.

Mr. Carey: Ready.

The Clerk: Will counsel please state your appearances for the record?

Mr. Carey: Kenneth S. Carey and Joseph S. Rogers for the Petitioner.

Mr. Boyle: Edward H. Boyle and Joseph D. Holmes, Jr., for the Respondent.

The Court: You may proceed, Mr. Carey.

Opening Statement on Behalf of Petitioner

Mr. Carey: If the Court please, this case involves three separate years but the issue or issues involved in each year are identical. In each of 1952, 1953, and 1954, the Petitioner here purchased from various real estate brokers in the City and County of San Francisco preliminary title reports and/or title insurance policies to be used by the Petitioner in its title plant as an aid to searching title. These purchases were made in cash, that is, currency. They totaled in 1952, \$6,896.00. In 1953 there was \$8,581.00, and in 1954, \$7,534.00.

Bay Counties Title Guaranty Company was organized in 1946. It actually commenced business in 1947, early in 1947. During the period from 1947 to January 1, 1952, [3] Bay Counties capitalized all of their abstracting, all of their title information. This is a five-year period. The practice in the

industry is that after a title company has been in active business for five or more years, they are deemed to have a sufficient plant for efficient preparation of title searches for efficient management of their title business. During this five-year period at least, and probably in excess of, \$25,000 was expended by the Bay Counties Title Guaranty Company to bring their title plant to a peak of efficiency.

Now, during this period a number of these preliminary reports and title insurance policies were purchased also and the costs of these were capitalized during this period. Beginning in 1952 the costs of searches, the costs of the daily abstracts, and so forth, were expensed and charged to current operating expenses and so also were the sums here involved.

Now, as I understand, and as I see this case, there are two issues involved and only two issues and they are common to all three years. No. 1: Should these expenditures be capitalized, and No. 2: Were these expenditures disguised payments of commissions through real estate brokers, violative of the Insurance Code of the State of California. As I understand this case, it resolves itself into those two issues.

The Court: Does the Government concede that if these payments are payments for the legitimate acquisition of copies of title policies or other information relating to titles, that [4] they can be expensed?

Mr. Boyle: No, your Honor. We say that those are capital in nature. Do you wish me——

The Court: Well, if the expenses were not exactly what they should be, what is your view about them? They cannot be capitalized either?

Mr. Boyle: Well, we believe the evidence will show that actually they were not purchasing anything.

The Court: What is the answer to my other question?

Mr. Boyle: If they were purchasing something, we think then that the expenditures should be capitalized, that they were not expense items and this was a part of the plant.

The Court: I think you didn't get the point of my second question.

Mr. Boyle: I am sorry.

The Court: From reading the pleadings it appears that the agent has taken the view that these particular payments in each of the taxable years were refunds to brokers and such refunds to brokers violate either a statute here or a code provision or something. Now, supposing the evidence showed that these payments were some sort of rebate. What is your position about the item then as an expense?

Mr. Boyle: That it is not allowable because——

The Court: Allowable as what?

Mr. Boyle: It is not a deductible item because it [5] is in violation of public policy.

The Court: That would be in case they could take a deduction at all. What about capitalizing the item?

Mr. Boyle: If they were not really buying anything and these were pure and simple rebates, as I assumed your question to be, there would be no question of capitalization. It would just be a payment in a year to a real estate broker. They could not advance under any theory of capitalization there.

The Court: Without taking too much time, what is your view about these payments? What does the Government contend the payments are?

Mr. Boyle: First that they were just rebates or kickbacks.

The Court: Enlarge on that. Why do you think they were rebates?

Opening Statement on Behalf of Respondent

Mr. Boyle: This company incorporated in 1946. It commenced business in 1947 and in those early years it made these payments to these real estate brokers without regard to these so-called title policies.

The Court: What for?

Mr. Boyle: To get business. See, they are just a brand new starting corporation and to compete

with the big title companies they had to bring in business. One means of [6] doing it was to pay the brokers to bring the business to them.

The Court: What kind of brokers?

Mr. Boyle: Real estate brokers and agents. Now, if the real estate broker came along with the business and had some kind of a preliminary report or title policy on the policy involved in the transaction that he was bringing into this title company, they would be happy to have that, too, but they were not paying for it. They were paying him 10 per cent of the escrow fee and the total title policy together to bring the business.

Now, in 1949 the big four companies here, California Pacific Title and the other big three, put law into the State Code to prevent this. Well, this corporation apparently did not feel, and the others did not feel, that it had enough teeth so they didn't pay any attention to it. In 1951 the big four did put in provisions which did have teeth and it is still present in the California Insurance Code. At that time they acquired the idea from a title company down in San Mateo that maybe they could get around this by buying these policies and at that time they started doing this.

Now, however, they still pay on a percentage of the escrow fee alone and they will take, under their theory of the case, any title policy or any preliminary title report. That is, it does not have to relate to the property that is in the business at hand. It

can relate to anything and they [7] will buy duplications, get two things on the same property. They have no means of assembling it or identifying it or screening it and they can't even tell today what they did buy. All they can say is they bought something, so we think that they were still basically trying to bring in the business by just making payments to the real estate brokers. But we say secondly that if the Court should find that they started buying something in 1952, what they were buying is still a part of their total plant and must be capitalized because they have not got starters on all the property in San Francisco. Some of the starters—by “starter” I mean a preliminary title report or a title policy issued by some other company—may date back 10 or 15 years or it may be more recent, but what they say it enables them to do is to abstract the title only part of the way and therefore they will rely on someone else's search prior to that.

You see, this corporation does abstract. But it does not issue insurance. It just recommends and another company actually issues the insurance, but we say that the evidence will indicate that what they were doing in our years was the same thing as in former years, in other words, bringing in business.

The Court: What is the statutory provision to which you have reference?

Mr. Boyle: Section 12404 of the Insurance Code. It speaks of prohibited commissions. [8]

“No title insurer, no controlled escrow company, and no underwritten title company shall pay to any

person who is acting as agent, representative, attorney, or employee of the owner, lessee, mortgagee or of the prospective owner, lessee or mortgagee of the real property or any interest therein, either directly or indirectly, any commission, or any part of its fees or charges or any other consideration as an inducement for or as compensation on any title insurance business or any escrow or other title business in connection with which a title policy is issued."

Now, there is a criminal penalty, too, for violation. That is Section 12409, in case there is an unlawful rebate.

The Court: What is this section, Section 12404?

Mr. Boyle: Yes, 12404.

Mr. Carey: Of the Insurance Code?

Mr. Boyle: Yes, of the Insurance Code of California.

The Court: And you say this Petitioner is an underwritten title company?

Mr. Boyle: Yes, it is.

The Court: Spell that.

Mr. Boyle: Underwritten, u-n-d-e-r-w-r-i-t-t-e-n.

The Court: Title company?

Mr. Boyle: Title company.

The Court: What is an underwritten title company, Mr. Carey? [9]

Mr. Carey: If the Court please, that is a company that has facilities for making sure of the state of the record title and whether the record title is the proper title, but does not itself issue any title insurance. It will provide the escrow

services but another company of whom this company is an agent actually issues the title insurance policy. In every transaction involving title insurance there are two separate and distinct services provided. There is the escrow service and the title insurance service. Now, the title company or underwritten title company provides the escrow service and in effect guarantees the title, but the actual insurance is written and issued by another company.

The Court: What is the name of the company you work with?

Mr. Carey: Bay Counties Title Guaranty Company.

The Court: I think we might be able to dispose of one matter if I ask this question.

Does the Petitioner know to whom the various payments were made in each of the taxable years which aggregate the totals we have before us?

Mr. Carey: Yes, your Honor, we do.

The Court: How many payments are involved?

Mr. Carey: There are quite a number of payments, if the Court please. Our records show those but there would be probably 20 or 30 payments in a year, or more. [10]

The Court: Have you had those listed? Are they typed out?

Mr. Carey: No, your Honor, they are not.

Mr. Boyle: If your Honor please, we would request permission to be able to see their books now. We might save some time. We have not been able to obtain those books and if we can——

The Court: Mr. Carey, I can't take the time to get that sort of detail by the interrogation method.

Mr. Carey: I understand that.

The Court: Now, you know what the payments were and to whom they were made in each year?

Mr. Carey: Yes, ma'am.

The Court: And after all, one question that has to be decided is: What were these payments?

Mr. Carey: That is correct.

The Court: Unless I can identify individual payments I can't answer the question. I can't decide the question as to what each payment was for. That is perfectly obvious. But perhaps I should mention it because you might think that I would deal with the matter in a general way. No. I will want to know about each payment.

Mr. Carey: If the Court please——

The Court: We are dealing with individual payments. Some might be all right and some might not. The only way I can [11] decide that question is to know about each individual payment.

Well, we are not going to take the time to locate each individual payment and the amount of each payment through the system of interrogation. That would take too long. So I want a typed list of the payee, the date of the payment, the amount of the payment and the total of all the payments, and anything else—why the payment was made, whatever else you have to identify the item.

Now, if you then wish to examine some witnesses about that material, at least I have the material in collected form to use for the purposes of finding

some fact in the case. Now, when can you get that?

Mr. Carey: I think that we can lodge it with the Court——

The Court: It doesn't have to be typed now. If someone will take a pad and pencil and write it up, if you have that.

Now, on the matter of the request of Respondent to look at some material, I don't know what you think about that. Have you stipulated any facts?

Mr. Carey: Yes, your Honor. We were going to lodge those with the Court at this time. The Articles of Incorporation of——

The Court: Let me see these.

Mr. Carey: ——of the Petitioner. The United States [12] would like leave to make copies of that, so——

Mr. Boyle: May I interject at this point, your Honor, with regard to what they are going to provide in the way of listing these payments?

The Court: Yes.

Mr. Boyle: First of all, the stipulation of facts is only general and will help very little.

The Court: That is not unusual.

Mr. Boyle: What the Respondent would like, first of all, there are two books of record. The first shows checks drawn to cash or to Mr. Rolls, the President of the corporation. We would like those checks, that is, the amount and the date, because it will be admitted that Mr. Rolls cashed those checks and took the currency and paid the real estate brokers in currency.

The Court: Is Mr. Rolls going to be one of your witnesses?

Mr. Carey: Yes.

The Court: How many witnesses are you going to have, Mr. Carey?

Mr. Carey: We are going to have four witnesses.

The Court: I understand your suggestion. Now, what is your next suggestion?

Mr. Boyle: The next suggestion relates to the specific point that you were talking to Mr. Carey about. The [13] next record is called a daily ledger and that will show the names of the real estate brokers. It will show two columns of figures, the first being the escrow fee handled by that particular broker and the second column will be the amount paid the broker, so we would like not only the amount paid the broker but also that other column of figures, the total escrow fee, to show—to show the comparison or the relationship between the payments and that fee.

The Court: To see if there is a uniformity?

Mr. Boyle: Yes, a percentage applied.

The Court: I suppose the Petitioner would rather not provide you with that information. Did you subpoena it?

Mr. Boyle: Yes, we have. They are here and we can put it in the hard way. We have not been able to look at it.

The Court: I am going to cut through this right now in this way. We will call Mr. Rolls to the stand right now and we will also ask the Petitioner to produce those books right now.

Now, if those records have been subpoenaed, produce them, please.

Mr. Carey: They are here. I take it the United States is calling Mr. Rolls to the stand?

The Court: I don't know. We just called him, the Commissioner or the Respondent here. You don't have to refer [14] to the Respondent here as the United States. The title of this is Bay Counties Title Guaranty Company against Commissioner.

Mr. Cary: The point I am making——

The Court: If you want to call Mr. Rolls, call him. If Mr. Boyle wants him he can call him.

Mr. Boyle: I would rather do so when our case comes on.

The Court: Now, I am going to—now, I assume that we know and can delay until later some of the background questions that would be asked. Now, the nub and the heart of one of these issues is simply: What were these payments? To whom were they made and why? Now, let's get at that right away because we were here all day yesterday hearing a so-called three-hour case.

Now, I have allowed most of today for this and maybe we can finish it this morning.

Mr. Boyle: If your Honor please, I would request that they go in the proper order. If on the other hand, you wish otherwise, we will be happy to proceed.

The Court: I want to proceed this way. Call Mr. Rolls.

Mr. Boyle: For me to call him?

The Court: Yes, you call him.

Mr. Boyle: Mr. Rolls, will you take the stand?

Whereupon, [15]

JACK M. ROLLS

was called as a witness on behalf of the Respondent and, having been first duly sworn, testified as follows:

The Clerk: State your name and address for the record.

The Witness: My name is Jack M. Rolls, 135 Hayes Street.

The Court: I will ask Mr. Rolls a few questions. Mr. Rolls, be seated, please.

What is your position in the business of the taxpayer here?

The Witness: I am the President of the company, your Honor.

The Court: Are you in charge of the regular records of this concern?

The Witness: Yes.

The Court: Now, one of the questions here is: For what were these payments made? And the Court, in order to save time—you have heard me say this. I want to find out what the details were. Now, I would like to get at that right away and then revert to the usual order because it may be necessary for you to ask someone to write up something or make a detailed schedule. Will you pro-

(Testimony of Jack M. Rolls.)

duce your books and records showing—I guess it would be your daily ledger—showing the payments of the escrow fees and the other amounts [16] paid to brokers during the years 1952, 1953 and 1954, which give rise to the problem in this case.

Also, Mr. Boyle, let me have the income tax returns of the taxpayer, the stipulation of facts as received. There is one exhibit attached which is Articles of Incorporation. That is received. Now, is the Articles of Incorporation supposed to be a taxpayer's exhibit or a government exhibit?

Mr. Boyle: 1-A, your Honor.

The Court: It is just referred to as A in the Stipulation of Facts.

Mr. Boyle: I just signed this this morning. Exhibit 1-A is all right or it could be A but it is attached to the stipulation so it should be 1-A.

The Court: All right. The Certificate of Incorporation is received as Joint Exhibit 1-A in evidence and 1-A may be withdrawn and a copy substituted, whatever copy you want to make.

(Respondent - Petitioner's Exhibit No. 1-A was marked for identification and received in evidence.)

The Court: The Respondent has produced the returns for 1952, 1953 and 1954 and these are received as Exhibit B, the return for 1952, Exhibit C, the return for 1953, and Exhibit D, the return for 1954, with leave to withdraw and substitute photostatic copies as is usually done.

(Respondent's Exhibits B, C, and [17] D, were marked for identification and received in evidence.)

The Court: Now, did the taxpayer deduct in these returns these particular items as separate deductions or did the agent cull them out of some other deduction in his examination?

Mr. Carey: They were deducted as separate deductions, that is, under a separate category.

The Witness: Excuse me, I don't think that they were. They were grouped as a total advertising expense.

The Court: They were included in advertising expense?

The Witness: Yes.

The Court: That is what seems to be said in the Petition. That's right. Well, then, when you have marked those returns I want them back.

Do you know enough about these returns to find out where the advertising expense is in which these amounts might have been included or would your books show it better?

Mr. Boyle: Do you care for me to supply any information on that point?

The Court: Yes.

Mr. Boyle: They will not show it. They are lost in the total of advertising. There would be no way to pick these amounts out.

The Witness: That's what I was getting at. [18]

The Court: What did they deduct for advertising in each of these years?

Mr. Boyle: What we are talking about here,

(Testimony of Jack M. Rolls.)

these payments made to real estate brokers. That is part of the advertising, the only thing.

The Court: All right. I can pass it over.

The 1952 return shows a deduction for advertising expense in the amount of \$7,195.83. Now, apparently there was included in that figure \$6,896.00.

Mr. Boyle: That is correct.

The Court: Well, now, you see why I want to know the figures because the item that is being questioned constitutes most of what is deducted as advertising. That's why I want the figures. It's not too much lost in that. In 1953 Mr. Rolls points out that the deduction for advertising and entertainment is thrown together. It is \$12,236.62, and of that amount \$8,581.00 is being questioned. Then in the return for 1954 they deducted as advertising and entertainment \$12,755.19 and of that \$7,534.00 is being questioned.

Now, Mr. Boyle, what is it that you want to see before we go ahead? Do you want to see some of their accounting records?

Mr. Boyle: No, we want to put into evidence what those accounting records show.

The Court: What do the accounting records show? [19] Your agent has been over them.

Mr. Boyle: That was three or four or five years ago, if your Honor please. We would like to show the manner of payment. There is no question, I take it, that Mr. Rolls will state that he made these payments to these real estate brokers in currency.

Mr. Carey: So stipulated in the stipulation.

(Testimony of Jack M. Rolls.)

Mr. Boyle: That is correct, so stipulated, and we want to show how the currency got into Mr. Rolls' hand. That is, a check drawn by the corporation which Mr. Rolls cashed and then took the currency.

The Court: That would all have to do with method. I suppose you could call Mr. Rolls as your witness or you could cross-examine him about that.

Now, I want to try to save some time. What does your revenue agent's report show? Why should we have to do over again what your revenue agent has done once?

Mr. Boyle: If Mr. Rolls will admit what I have just said, we can eliminate that particular record. If Mr. Rolls will——

The Court: All right. I don't know what he is talking about, but if you get some records I am not going to put them in evidence at this time. I don't want to jeopardize your case at all. I just want to try to save some time and find out where we are going. Then I will see that we proceed [20] properly.

Just step down, please, and go over to the counsel table with those ledger sheets. Let's see what Mr. Boyle is getting at.

Now, Mr. Boyle, what do you want? There are the ledger sheets.

Mr. Boyle: I will have to take a few minutes to have the revenue agent look at this. I have never seen it.

The Court: Where is your revenue agent? Move over, please.

(Testimony of Jack M. Rolls.)

Are you Mr. Holmes?

Mr. Holmes: Yes, your Honor.

The Court: All right. Move over to that other chair, please. Let the revenue agent sit down there. Don't be concerned, Mr. Carey. We will get back to our usual procedure in a few minutes.

What is the revenue agent's name?

Mr. Boyle: Mr. James Compton.

The Court: Mr. Compton, do you have your report with you this morning?

Mr. Compton: Mr. Boyle has it.

The Court: Mr. Boyle has the report. We shouldn't have to go over this, all over again. What are you going to look for? Are you going to look for specific items of payment? Let's find out what you are trying to get at. [21]

The Witness: Your Honor, I could point them out. I know where they are.

The Court: The Petitioner admits that these payments were made in cash, apparently, and the books show the payments. Under what account were these payments entered?

The Witness: Listed under advertising.

The Court: They were listed under advertising and what do you want, Mr. Boyle? Do you want to spot them in the——

Mr. Boyle: What I thought, I would if I could see the books we would have picked these items out and introduced these sheets in evidence. If the Court does not wish for us to go through that, with this particular record, it just shows amounts drawn to either cash or Mr. Rolls or to——

(Testimony of Jack M. Rolls.)

The Witness: Not to me.

Mr. Boyle: But in any event the checks were then cashed by Mr. Rolls, the cash taken and used to pay real estate brokers in these years involved.

The Court: I think all that you would find would be something like this: This is an account in the book under the caption of advertising expense, and Mr. Rolls has a check drawn to cash and cashes the check. The check is in the amount of \$535. Now, an expenditure of \$535 is debited to this account. That is all.

Mr. Carey: I think you will find more than that.

The Court: What else are you going to find?

Mr. Carey: You are going to find in each instance that the check notation is "cost of reports."

The Court: In the explanation?

Mr. Carey: In the explanation.

The Court: Let's see. Those are ledger sheets. There has to be reference to a journal, then.

The Witness: No, they are direct daily entry.

The Court: This sort of inquiry is what I have in mind when I say just give me a typed list of these items. Then nobody has to look through the pages to find them.

Mr. Carey: We will provide that, your Honor. We will provide from the ledger sheets the entry in each instance and we will provide a summary of it in typed form.

The Court: There is no harm in taking a recess for a minute, now that Mr. Boyle for some reason wants to look at those ledger sheets.

(Testimony of Jack M. Rolls.)

The Witness: Your Honor, I was thinking perhaps we could photograph or have copies made of these sheets, these pages which are the records.

The Court: I haven't the time. My time is so short, Mr. Rolls, that I really don't have the time to take 20 ledger sheets—if you took 20 ledger sheets and put a red mark opposite an entry and said, "Well, now, there it is." I wouldn't have the time to look at the 20 sheets and find the [23] 20 red dots, because we have to write findings of fact and I would have to take—it's raw material, and I would have to take it and make up a table and have it typed and I don't want to have to do that. You make up the table and have it typed.

Mr. Carey: We will do that, your Honor.

The Court: We want to know what expenditures total \$6,895.00 and the facts about them. If every one of those items was credited or debited to some particular account, I want it written out, but I will not take the time to put together all the details from your books. In other words, when you get to this point the Tax Court is going audit nothing. The revenue agents audit things and whoever is preparing the case can make summaries and present them to the Court, but the Court has no time to make up tables, schedules, or anything else.

I will give you a few minutes to check whatever you want to there and then we will get back to the usual order of business.

(Short recess.)

(Testimony of Jack M. Rolls.)

The Court: Mr. Carey, when the taxpayer received the—I suppose it was a 30-day letter, you had a conference with the agent here?

Mr. Carey: Yes, we did.

The Court: I suppose you found out how these totals [24] of additions to income were arrived at, the total amount for each year?

Mr. Carey: Yes.

The Court: Now, we have seen during the recess a work sheet of the agent. It was in the nature of a work sheet. He has taken some of the taxpayer's records and put some red figures on them.

Mr. Boyle: Those were the taxpayer's records. They are his records.

The Court: Well, they are the taxpayer's records but in a sense they have become a work sheet of the agent because the agent put some red figures on them.

Mr. Boyle: No, your Honor, no figures on there were put on by the agent. Those were all records kept by the Petitioner in this case.

The Court: All right. Then, they are the taxpayer's notations on his own records. Now, the agent must have totaled some figures because he comes out with additions to income in each of the taxable years of a certain amount. Where are the agent's work papers?

Mr. Boyle: If your Honor please, the agent in auditing those records you refer to took all the payments to real estate brokers and disallowed them. The only record the agent made for his own

(Testimony of Jack M. Rolls.)

purpose, he took over a period of three months in those three years enough down so that he could [25] write his report and therefore state that the amount paid the real estate broker totaled 25 percent of the escrow fee, but no memorandum of the agent is here or has been shown to the Court or anything yet. Those are all the records of the Petitioner that we were looking at.

The Court: So you intend to, during the trial of the case, bring this before the Court and your method would be to ask the taxpayer to produce these accounting records, offer in evidence the accounting records themselves, withdraw them and have them photostated, then ask the Court to audit them and find out if \$6,896.00 equal a certain percentage of something else, and I won't do it.

Mr. Boyle: If your Honor please, I don't think that will be necessary, if we put them in evidence. I think in our briefs——

The Court: I won't wait to have things done in briefs.

Mr. Boyle: There will not be any dispute——

The Court: There may be and I will not wait to have that sort of thing done in briefs. Do it during the trial of the case and then you can put in your brief what has been put into your record of the trial of the case.

Mr. Carey, how much of this do you admit, because this ought to be a fairly cut and dried matter. There were payments made to brokers. They may have been perfectly normal [26] legitimate payments.

(Testimony of Jack M. Rolls.)

Mr. Carey: There were payments made to brokers. There is no question about it.

The Court: And they were, you agree, do you, that there were payments made to brokers in the total amounts for each of these years that have been added to the taxable income?

Mr. Carey: Yes, that is stipulated.

The Court: That you agree to?

Mr. Carey: Yes, ma'am.

The Court: And you also agree that these were charged to advertising expense on the books?

Mr. Carey: For the most part.

The Court: For purposes of this case, I suppose we can say that they were?

Mr. Carey: Yes, your Honor.

The Court: You agree as to the method that was used in making these particular payments to brokers, that they were all made in cash?

Mr. Carey: Yes, your Honor.

The Court: But we don't have the breakdown of any of these amounts. We don't know who the brokers were, we don't know what they are doing, we don't know why you were making the payments?

Mr. Carey: That is correct. [27]

The Court: And we can take a lot of time to make a record on that sort of detail and I propose that we do that without taking a lot of time and without doing it in detail. Now, it's up to you to figure out how to do it and it will have to be done during the trial of the case and not on briefs.

Mr. Boyle: I have this suggestion: If we were

(Testimony of Jack M. Rolls.)

allowed to put those records in evidence, and then by Friday before the Court leaves, the parties will type up the material information on those sheets and then submit that as a typewritten summary.

The Court: You will get to the time for putting in evidence as we proceed. I don't know whether you want to put them in now or not. It would seem to be out of order. I think the best thing for us to do is to let the matter alone for the present time. I have indicated what I will have to have. Petitioner has his own plan of going ahead and so I think we better let you go ahead, Mr. Carey, in the usual way.

Mr. Carey: I would like to call Mr. E. A. Smith, please.

Whereupon,

ELIAS W. SMITH

was called as a witness on behalf of the Petitioner and, having been first duly sworn, testified as follows: [28]

The Clerk: State your name and address for the record.

The Witness: Elias W. Smith, 408 South Spring Street, Los Angeles, California.

Direct Examination

Q. (By Mr. Carey): What is your occupation, Mr. Smith?

A. I am in the title insurance business.

Q. By what company are you employed?

(Testimony of Elias W. Smith.)

A. Pacific Coast Title Insurance Company.

Q. What position do you hold?

A. I am Secretary-Treasurer.

Q. How long have you held such position?

A. Since February of 1950.

Q. How long have you been in the title business? A. Ten years.

Q. Are you familiar with title practices of title companies and underwritten title companies, generally, in California? A. Yes, I am.

Q. It is correct, is it not, Mr. Smith, that the Petitioner in this case is an agency of your company? A. That's correct.

The Court: Explain that. In what way? What is the Pacific Coast Title Company? [29]

The Witness: We are the underwriting company, your Honor.

The Court: What is the business of the Pacific Coast—what is the full name of the company?

The Witness: Title Insurance Company.

The Court: What is your business?

The Witness: Issuing title insurance policies, insuring on titles.

The Court: All right. You say you have agents?

The Witness: Yes.

The Court: And this taxpayer is an agent of your company in this area, is that right?

The Witness: Yes, that is true.

The Court: What is the scope of the agency? In what way is this company an agent?

(Testimony of Elias W. Smith.)

The Witness: They have the exclusive agency of issuing our policies in the San Francisco County.

The Court: All right. Then, if a purchaser and seller of real estate comes to them they provide the escrow service, is that right?

The Witness: They conduct the title search and examination and request us to issue our policy of title insurance.

There is an Assistant Secretary of ours within that company to issue that policy. [30]

The Court: What is his name?

The Witness: Mr. Rolls.

The Court: Are any of your records available for that title search?

The Witness: The records for the search and examination are in the offices of Bay Counties Title Guaranty.

The Court: They are a new company. They have been building up a business here?

The Witness: Yes.

The Court: Do you maintain title records?

The Witness: Oh, yes, we do.

The Court: Does Mr. Rolls use some of your title records?

The Witness: No. The records for San Francisco County are retained in San Francisco.

The Court: Those records then that are retained in the office of Bay Counties Title Company, were some of those records obtained from your organization?

The Witness: No, ma'am.

(Testimony of Elias W. Smith.)

The Court: In the first instance?

The Witness: No.

The Court: How long has Pacific Coast Title Insurance Company been in existence?

The Witness: Since 1944.

The Court: So you are a new company here? [31]

The Witness: Yes, we are.

The Court: Go ahead.

Q. (By Mr. Carey): From your experience and knowledge of the title business in California, Mr. Smith, is it a common practice for title companies to purchase preliminary reports or copies of title insurance policies? A. It is.

The Court: Who do you purchase them from?

Q. (By Mr. Carey): From whom are they purchased, Mr. Smith?

A. Realtors, escrow companies.

Q. Wherever they can be obtained?

A. Wherever they can be obtained.

Mr. Boyle: I would like to take this witness on voir dire. He is apparently trying to qualify him as a man qualified to talk about custom.

The Court: Objection overruled.

Q. (By Mr. Carey): Do you know of specific instances where this is done or was done in the years 1952 to 1954, other than Bay Counties?

A. Yes, I do.

Q. And it is done today?

A. That is correct. [32]

Q. Would you tell the Court of those instances that you know about?

(Testimony of Elias W. Smith.)

A. I merely know of other companies which have purchased title starters from people we have mentioned here.

The Court: You used the term "title starters." What is a title starter?

The Witness: That would be the preliminary reports and policies.

Mr. Boyle: I ask that that answer be stricken as hearsay based on hearing from someone else, not of his own personal knowledge.

The Witness: I know it of my personal knowledge.

The Court: Do you know that? All right.

Q. (By Mr. Carey): Is it not a fact, Mr. Smith, that when necessary the Pacific Coast Title buys starters, as you call them, preliminary reports?

A. When necessary, yes.

Q. Your records of your organization in Los Angeles would show this fact, would it not?

A. Yes.

Mr. Boyle: I suggest you let the witness testify.

Mr. Carey: If you want to make an objection, Mr. Boyle, all right. There are proper ways to make an objection. [33]

Q. (By Mr. Carey): Mr. Smith, has your company ever been audited by the Insurance Commission of the State of California?

A. Yes, they have.

Q. How recently?

A. The last audit was completed in July of last year.

(Testimony of Elias W. Smith.)

Q. How frequently are they audited?

A. On an average of every three years. In our case it was five, this last time.

Q. Did I understand your testimony correctly, that your records would show purchase of these preliminary reports? A. That is true.

Q. What agency is it that has jurisdiction over title insurance companies and underwritten title companies? A. The Insurance Department.

Q. Of the State of California?

A. Yes, California.

Q. What comment, if any, was made upon the audit of your company concerning the preliminary reports, the purchase of the preliminary reports?

A. None whatever. They—may I correct that? They did see where they had been purchased and they asked what this was. It was discussed. There was no objection raised by the department.

Q. To your knowledge, have any charges ever been placed against any title insurance company by the Insurance [34] Commissioner because of practices such as you have described?

A. Not to my knowledge.

Q. Do you know of any charges ever having been placed against the Petitioner in this case because of these practices?

A. Not to my knowledge.

Q. Mr. Smith, does your company underwrite several title companies in the State of California.

A. We do.

Q. How many? A. Ten.

(Testimony of Elias W. Smith.)

Q. Other than Bay Counties or including Bay Counties? A. Including Bay Counties.

Q. And these companies, Mr. Smith, you are somewhat familiar with? A. I am.

Q. Do they follow similar practices of buying preliminary reports and title insurance policies when the occasion demands?

A. When necessary, yes.

Q. So that would you say this is a common practice? A. Yes, it is.

Q. Now, suppose, Mr. Smith, that there were an arrangement whereby in a given area—let's say the City and County of San Francisco as the suppositive area—that there were, let's say, five title insurance companies and of the five title insurance companies, four of them got together [35] and they had an agreement which was something like this: Let's say Company A, having a transaction on which it was requested to issue title insurance, in examining the record found that two or three years or five years ago, Insurance Company B had handled a transaction involving that property.

Now, upon request Company B would furnish Company A with a copy of its title insurance policy and a letter of indemnity insuring Company A against any loss sustained by any defects of title not excepted in the policy.

Would this put the person or the company which was not a member of that group to a competitive disadvantage? A. Very definitely, it would.

(Testimony of Elias W. Smith.)

Q. In what way, Mr. Smith?

A. By the exchange of these policies with these other companies that you mentioned, it would save them considerable money in the production of their own policy.

Q. How do you mean, save them money?

A. As far as searching the records.

Q. In their title search it would save a great deal of money?

A. In the title search, yes.

Q. Do you know, Mr. Smith, whether there has been any discussion in the title business concerning the practice of buying title insurance policies or preliminary reports from [36] real estate brokers and whether that violates any provision of any law or regulation of any agency in the State of California?

The Witness: Will you repeat the question?

(Question read.)

A. Not to my knowledge.

Q. (By Mr. Carey): This question has never been raised publicly, to your knowledge?

A. No.

Q. As Secretary-Treasurer of the Pacific Coast Title Company, Mr. Smith, you are familiar with the operating practices and procedures of the companies who are agents for you? A. Yes.

Q. May I ask you: Is it your function to be sort of a watchdog over these people to maintain the integrity of your company? A. Yes.

(Testimony of Elias W. Smith.)

Q. You are familiar with the fact that Petitioner in this case purchased title insurance policies and preliminary reports from brokers?

A. Yes.

Q. You have examined the facts and the evidence in the matter. Have you ever found any evidence that Petitioner [37] in this case was making disguised payments to real estate brokers? A. No.

Mr. Carey: That is all.

Cross Examination

Q. (By Mr. Boyle): How old are you, Mr. Smith? A. Thirty-five.

Q. When did you go to work for Pacific Coast Title Insurance Company?

A. Ten years ago.

Q. You were twenty-five then? A. Yes.

Q. Was that your first introduction to the business?

A. To the title insurance business, yes.

Q. You have never worked for any other company? A. Yes. Not a title company.

Q. That is what I mean.

A. Yes, that is correct.

Q. No other title company. So in testifying as to custom, you were testifying as to what the Pacific Coast Title Insurance Company does, isn't that correct?

A. I am testifying as to what employees who are now employed with us have told me, as well as facts I have found out on my own. [38]

(Testimony of Elias W. Smith.)

Q. What they told you, is that correct?

A. Yes.

Q. Whatever knowledge you have is what someone told you, unless it occurred during your employ with Pacific Coast Title Insurance Company. Is that correct?

A. That's correct.

Q. So you are not in a position to talk about the custom of anyone other than the Pacific Coast Title Insurance Company unless you based your conclusion on what someone told you. Is that right?

A. That's correct.

Q. What documents exist that show the relationship between the Petitioner and the Pacific Coast Title Insurance Company?

Mr. Carey: I object to that on the ground that it is immaterial to any issue before this Court and we are going pretty far afield to show this.

The Court: What is the purpose of that question?

Mr. Boyle: They are called an agent and I wondered what the relationship, if any, was and what watchdog position he might hold, if any. I don't know the relationship between these people. I was wondering what that relationship might be. Now, they have been called an agent.

The Court: Well, instead of asking for any documents, why don't you ask the questions? [39]

Mr. Boyle: I don't believe that this witness would be qualified to answer. I would like to see the instrument.

The Court: He is an officer of the corporation. He ought to be qualified to answer.

(Testimony of Elias W. Smith.)

Mr. Boyle: Yes, your Honor.

Q. (By Mr. Boyle): On what basis do you call Petitioner here an agent of the Pacific Coast Title Insurance Company?

A. It's a contractual relationship.

Q. Contractual, is it in writing?

A. It is.

Q. Do you have the contract with you?

A. No, I do not.

Q. (By the Court): Is "agent" the right word or would "affiliate" be better?

A. I think probably either would be appropriate.

Q. Does this taxpayer pay over any funds to you? A. They do.

Q. What is the basis for their payment of funds?

A. The payments of risk premium on the policy issued.

Q. That is payment of a premium?

A. That's correct.

Q. Why do you call this concern an agent rather than [40] affiliate? Does it sell anything for your concern?

A. Our title insurance policies.

Q. Do you regard it as making sales of your title insurance policies? A. Yes.

Q. And in that respect, then, that is what you mean by agent? A. Yes.

The Court: Go ahead.

(Testimony of Elias W. Smith.)

Q. (By Mr. Boyle): Do you recall the hypothetical question put to you by Mr. Carey regarding five alleged organizations in San Francisco? Would you repeat the material facts of that hypothetical question on which you based your conclusion?

A. Well, as I understand it, the other four companies in San Francisco exchange policies of title insurance. For example, as I recall, one company, Company A, will issue a policy of title insurance. On a subsequent date an order will be placed through another company and the second company can go to this first company and use their policy of title insurance as a basis to begin their title search, rather than searching the records from scratch.

The Court: A pays B something for that?

The Witness: I don't know that. [41]

Q. (By Mr. Boyle): On what do you base that understanding?

Mr. Carey: I beg your pardon. I don't understand that question. I object to it because the question is confusing.

The Court: He means: How does he know that?

Mr. Boyle: How do you know that to be so?

Mr. Carey: I object to the question. It was a hypothetical question and he has not testified that he knows that to be so. The hypothetical question put to him was: Assuming that these facts were so, would this put the fifth company to a competitive disadvantage, and he said yes.

The Court: What are you going to do about your hypothetical question, Mr. Carey?

(Testimony of Elias W. Smith.)

Mr. Carey: We will bring the evidence in, not by this witness, but by other witnesses, that that state of facts exists in the City and County of San Francisco.

The Court: All right.

Mr. Boyle: That is all.

Redirect Examination

Q. (By Mr. Carey): Mr. Smith, during your tenure with the Pacific Coast Title Insurance Company, have you had occasion to meet with other executives of other title companies throughout the State of California? A. Yes, I have. [42]

Q. And discuss title business with them?

A. Yes.

Q. As I recall your testimony, it was that you had some ten agents such as the Petitioner in this case throughout California? A. Yes, we have.

Q. So that your knowledge of the industry is based upon discussions with people throughout the industry, isn't that correct?

A. That's correct.

Q. Is Pacific Coast Title Insurance Company a member of the American Title Association?

A. Yes, we are.

Q. And as a member of that title association——

Mr. Boyle: I object. He is far afield from his direct, far beyond his direct examination.

The Court: Objection overruled.

Q. (By Mr. Carey): As a member of the American Title Association, problems such as this are

(Testimony of Elias W. Smith.)

brought up and discussed in these meetings, is that correct? A. That's correct.

Q. So your knowledge of this business is not based upon what some employee told you, but upon problems discussed by members in the industry?

A. Yes.

Mr. Carey: Thank you. That is all.

The Court: I believe that is all, thank you.

Mr. Carey: Unless Mr. Boyle would like to have him remain, we would like to have Mr. Smith excused. He does not have to catch a plane immediately but he has a plane to catch late this afternoon.

Mr. Boyle: No objection. He can be excused.

The Court: You are excused. Thank you for appearing.

(Witness excused.)

Mr. Carey: I would like to call Mr. Dale Farnow.

Whereupon,

DALE FARNOW

was called as a witness on behalf of the Petitioner and, having been first duly sworn, testified as follows:

The Clerk: State your name and address for the record.

The Witness: Dale Farnow, 2672 Ocean Avenue.

Direct Examination

Q. (By Mr. Carey): What is your occupation?

A. Real estate.

(Testimony of Dale Farnow.)

Q. How long have you been a real estate broker?

A. I have been in the business about 12 years. I have been a broker about five years. [44]

Q. During the years 1952, 1953 and 1954, with whom were you associated?

A. 1952 I was Manager for Green and Kaufman. In 1953 and 1954 I was in business for myself.

Q. Who are Green and Kaufman?

A. Real estate brokers in San Francisco.

Q. During this 12-year period, have you been a broker in the City and County of San Francisco the entire period of time?

A. I was a licensee, not a broker that entire time.

Q. But in San Francisco? A. Right.

Q. Do you have any other connection with the real estate business, Mr. Farnow?

A. What do you mean?

Q. Are you a lecturer in real estate at any place? Do you do any lecturing?

A. Yes, I teach real estate practice at the University of California extension.

Q. How long have you been a lecturer at the University of California School of Extension?

A. Just this semester.

Q. Now, do you, as a real estate broker or licensee, Mr. Farnow, obtain a preliminary report on all transactions that you handle? [45]

A. Yes.

Q. This is a matter of routine?

(Testimony of Dale Farnow.)

A. Right.

The Court: What do you mean by transaction?

Q. (By Mr. Carey): By transaction, Mr. Farnow, I mean any pending or proposed sale or exchange of real property in which you might be the broker or the agent for either the seller or the buyer.

It would be a routine thing for you to obtain a preliminary title report, is that correct?

A. Yes.

The Court: I wish you wouldn't ask leading questions unless you have to. This man shouldn't have to be led.

Q. (By Mr. Carey): What does the preliminary report show insofar as the state of title of the property is concerned, Mr. Farnow?

A. Well, it shows the record title, the owner of record, and the tax situation, the liens against the property in the way of restrictions in the way of loans, the obligations of the present owner.

The Court: From whom do you get such reports?

The Witness: From title insurance companies.

The Court: Do you refer to them as preliminary reports? [46]

The Witness: Yes.

The Court: Suppose Smith is going to buy a piece of improved property, a residence out in the Ingleside area, from a man named Brown, and you represent Smith. Smith is the buyer and Brown is the seller.

(Testimony of Dale Farnow.)

Now, you want to be sure that Smith gets good title, don't you?

The Witness: Yes.

The Court: So just describe the transaction. Tell us what you do, what fees have to be paid, and all of that.

Mr. Carey: May we add one fact to that, your Honor?

The Court: All right.

Mr. Carey: Suppose you had also handled this piece of property in a deal prior to this transaction in question?

The Court: I don't want to assume that. I just assume that he is a broker for Smith who is going to buy a house from Brown. That is all I am going to assume in my question.

We are interested in what you will do preparatory to the closing and what you will do at the closing.

The Witness: In the event that an agreement to purchase is drawn between the two parties, the next step would be to call a title insurance company and ask that they send me a preliminary report of the status of the title. Upon receiving that report I would prepare a deed between the [47] seller and the buyer, using the legal description provided in that report. I would draw up a buyer's and seller's closing statement prorating the taxes as revealed by that preliminary report. I would make the arrangements to have any necessary documents to clear any liens shown in that report which were required to be

(Testimony of Dale Farnow.)

removed, deposited in the escrow. I would use a copy of that preliminary report to supply lender with the legal description, in the event that the lender was going to provide financing in the transaction.

When all these documents and the purchase money was assembled and placed in the escrow, I would instruct the title company to record the transaction with instructions from the buyer and the seller as to their demands, in the escrow, and from this point my responsibility would cease and the title company would record and issue an insurance policy.

The Court: How much do you pay for the preliminary report or don't you pay anything?

The Witness: In most cases we do not pay.

The Court: And the buyer will pay the title insurance company for the policy of title insurance?

The Witness: That's correct.

Mr. Carey: I believe, your Honor, that that may be the practice in San Francisco. In some places it is customary that the seller pay the insurance. In some places it is customary that the buyer pays the insurance. [48]

The Court: Yes, that varies from place to place. In Washington, D. C., the buyer pays for the policy of title insurance, not the seller.

The preliminary report that you have obtained was given by a concern that is in full position to subsequently issue a policy of title insurance?

The Witness: That is correct.

(Testimony of Dale Farnow.)

The Court: And presumably the policy of title insurance is going to purport to cover more than the preliminary report, is it not?

The Witness: It will be a more current coverage than the preliminary report, due to the interim of time from the issuance of the preliminary to the final status.

The Court: Well, the title insurance company is going to guarantee that Brown has a full and complete title that he can convey to Smith?

The Witness: No, the title insurance company is going to issue an insurance policy guaranteeing that the purchaser, Smith, has title to the property subject to certain conditions and naturally in doing so, they have had to ascertain that the original owner had the right to convey and did so in good title, but the insurance is to the buyer.

The Court: All right, it amounts to the same thing. The title company has to guarantee that there was good title to be passed along, is what the purpose of it is? [49]

The Witness: Yes.

The Court: In order to be able to make that guarantee they have to know something about the record of that property long before Smith was an owner. He is the seller in my hypothetical case, but the title company has to—presumably has a record going away back, isn't that right?

The Witness: To my knowledge this would be true. As I understand the title business, I am not an authority on it at all. They can insure title from

(Testimony of Dale Farnow.)

previous insurance which would eliminate the necessity of their actually abstracting the title back to the first record. In the event that a title insurance policy had been issued on the property for the previous owner, they could simply take the chain of title from that policy. That is my understanding, and insure it.

The Court: From the policy held by the previous owner?

The Witness: Yes.

The Court: Regardless of who issued the policy to the previous owner?

The Witness: This would depend upon the individual title company, and their interpretation of that policy, whether they wanted to. I simply say that I understood that they could do this and that they do it from time to time. We are occasionally asked in the real estate business if we can supply a title company with the previous insurance policy, if [50] the owner would supply it. For what purposes, I only imagine for the purpose of abstracting from that point on.

The Court: All right. Now, what is your next question?

Q. (By Mr. Carey): Mr. Farnow, are you acquainted with the Bay Counties Title Guaranty Company? A. Yes.

Q. Have you ever had any business transactions with them? A. Yes.

Q. Have you ever sold any preliminary reports or title insurance policies to them? A. Yes.

(Testimony of Dale Farnow.)

The Court: Wait a minute. Have you ever sold——

Mr. Carey: Yes, your Honor.

The Court: ——any preliminary policies to them?

Mr. Carey: This would be preliminary reports.

The Court: And you say you have?

The Witness: Yes.

The Court: I understand you are a real estate broker?

The Witness: That is correct.

The Court: I would understand from that that you handle sales and purchases of real estate? [51]

The Witness: That is correct.

The Court: Where do you get information, how do you get into the business of selling preliminary reports?

Mr. Carey: If the Court please, there is no testimony that he is in that business.

The Court: I am asking him that.

Mr. Carey: He gets them when the transaction comes into his office.

The Court: He hasn't testified and don't you testify for him, Mr. Carey.

Mr. Carey: I will take exception to that, if the Court please, and ask that the record show and I am asking that the record be marked to Mr. Farnow's testimony, that he has so testified.

The Court: The record will show whether he testified to that effect, but my recollection is that he has not so testified and it may be that there is a

(Testimony of Dale Farnow.)

difference of opinion between us and I certainly am going to clear the matter up.

Do you sell preliminary reports to other concerns? I don't know what to call this concern, Bay Counties Title Company. It doesn't appear to be in a position to insure titles. I don't know what they are, an escrow agent or what, but are there other concerns who are in business like the Bay Counties Title Company? [52]

The Witness: Well, here in San Francisco, to my knowledge, Bay Counties is the only escrow agent issuing insurance through an insurance company. I believe all the other insurance companies are in themselves insurance companies.

Q. (By the Court): Do you provide other insurance companies here with preliminary reports?

A. I never have, no.

Q. Bay Counties Title Company is the only company you have furnished with preliminary reports?

A. That is correct.

Q. Where would you get these preliminary reports?

A. Both preliminary reports and title insurance policies. In the event that——

Q. You have sold them both preliminary reports and title insurance?

A. Copies of title insurance policies.

Q. You would make copies in your office?

A. No. Copies held by either the owner of the property, the owner with whom I am dealing, or by

(Testimony of Dale Farnow.)

a second lien or first lien holder on the property, had a copy of the insurance policy.

Q. Who was willing to give it up?

A. Who was willing to give it up at the time of the pending sale in order to expedite the sale. I had learned that by providing this information to Bay Counties, I could expect [53] a much quicker preliminary report from them because the information provided in either a previous preliminary report or previously issued title insurance policy aided them in preparing their preliminary report for me.

Q. Well, it would be probably incorrect to say that you are in the business of providing people with preliminary reports because you have just done that in dealing with Bay Counties?

A. I believe it would be incorrect to say that I am in that business. I have only done that occasionally for Bay Counties, that's all.

Q. Mr. Carey has indicated in some way, by some question or some comment, that you would be able to furnish a preliminary report only if you had had a transaction in your office involving that particular piece of property at some previous time. Would that necessarily be so or what?

A. I am not in a position to abstract title at all from the County Records. The only time that I would have information would be either from a preliminary report issued by some insurance company which was in my possession or a title insurance report issued by some company that was in my possession.

(Testimony of Dale Farnow.)

Q. Well, supposing a piece of property out on Green Street near Fillmore that had an address of 3527—just so that we have an address of a piece of property—is on the market [54] and the people who are parties to that transaction go into Bay Counties Title Company. Now, you are not a broker in it at all. Might Bay Counties Title call you and ask you if you had any information about 3527 Green Street?

A. They might. It would be conceivable. I don't recall that they ever have.

Q. Supposing Bay Counties had no transaction on hand before them but they happened to know that at one time, or they might ask you: "Do you have any preliminary reports or copies of policies on properties that you could make available to us anywhere?"

Have they ever done that?

A. Yes. Have they ever asked me if I had preliminary reports on certain properties which I could supply them? Yes.

Q. Would you know why they were asking you for it?

A. I presume to aid them in making a current search on the property.

Q. Might it be to aid them in building up records?

A. Yes, I classified that in my interpretation as the same thing.

Q. How much do you charge for that kind of service?

(Testimony of Dale Farnow.)

A. I have never charged Bay Counties any specific fee. This is not a service for providing these reports. I have never charged them any specific fee. They have paid me but I have never issued a bill for any of these things. [55]

Q. What have they paid you?

A. The exact amounts I can't say. I don't remember. I never received from Bay Counties at any time a specific payment for a specific preliminary report. I provided them with several of them and they have used what they could.

Q. You provided them with what?

A. With several over a period of years, a great many actually.

Q. Were you always paid the same amount?

A. No.

Q. Did you know on what basis the amount you were paid was computed?

A. No, I do not.

Q. Did you ever ask?

A. No, I didn't.

Q. About how much would a payment amount to?

A. Well, I was in the habit of only collecting from Bay Counties for payment for my policies possibly once every six months.

Q. About how much would a payment amount to?

A. \$60, \$90, something like that.

Q. Would that be for one report or for several?

A. For several. Since I knew that Bay Counties used these reports and they were of advantage to them, every time I ordered a preliminary search or if I had a previous preliminary [56] report, I auto-

(Testimony of Dale Farnow.)

matically sent it to them. If they needed it or used it I never knew. If I had a title insurance policy from a previous transaction I sent it to them. Whether they used it or not, I didn't know.

Q. Was that because you like them? Why did you do it?

A. Because first of all, I appreciated the recompense and secondly because I knew that it would aid them in getting my preliminary back to me as quickly as possible, which was to my interest.

Q. You mean at some future time?

A. No. What I was referring to there, in the event that I made a transaction on a given piece of property and I had in my possession either the previous title insurance policy or a previous preliminary report, I would immediately send it to Bay Counties requesting a current preliminary and providing them with the old one.

Q. That is something other than we are discussing now. That would have to do with a particular transaction in which you are acting as a broker?

A. Correct.

Q. We are talking about your providing preliminary reports where there was no particular transaction pending.

A. Yes. That is correct. I have done that.

The Court: All right, Mr. Carey. [57]

Q. (By Mr. Carey): Which other title insurance companies in San Francisco have ever offered to buy any reports from you, Mr. Farnow?

A. None.

(Testimony of Dale Farnow.)

Q. Do you know of any reason why they are not interested in purchasing reports from you?

A. It would only be my own supposition. Possibly they are older establishments, and it is not necessary for them to do so, but they have never approached me and I have never asked them if they would be interested either.

Mr. Carey: I have no further questions.

Cross Examination

Q. (By Mr. Boyle): Mr. Farnow, from whom do you generally obtain these preliminary title reports that you say you asked for when you have a deal pending?

A. From various title insurance companies here in San Francisco.

Q. For instance, have you ever asked California Pacific Title Insurance? A. Yes.

Q. When they issue this, do they know who the buyer or the seller might be in that case?

A. When they issue the preliminary report?

Q. To you, yes. [58]

A. They naturally know—presume the seller is the man of record, that they will provide the name to me as the legal owner.

Q. I mean do you give them the name?

A. Yes.

Q. Suppose you represent the buyer, would you give them the buyer's name?

A. I have never represented a buyer since I have been in the real estate business.

(Testimony of Dale Farnow.)

Q. You do give them the seller's name?

A. Yes.

Q. You do not pay for that preliminary title report, though?

A. It could be. I have paid for them, yes.

Q. If you take the escrow business back to that California Pacific Title Insurance Company, they would be paid then, would they not?

A. In the event that the transaction for which they issued the preliminary report was negotiated through their office and eventually a policy of title insurance issued, there would be no charge for the preliminary report. It is presumed that this was——

Q. But they would charge for the escrow service?

A. They would charge for the issuance of the new title insurance policy. [59]

Q. Now, suppose you do not go back to them with this transaction but go to Bay Counties?

A. Yes.

Q. Who pays for that preliminary report then?

A. If I did such a thing I have no doubt whatsoever that they would send me a bill for the preliminary report.

Q. Oh, you have never done that?

A. No, I don't usually ask one company to give me a preliminary and then switch it to some other company, willy-nilly. Occasionally this happens through things beyond our control. Perhaps a lender requests a certain specific insurer but in that event we call the previous company and tell them

(Testimony of Dale Farnow.)

we are sorry that the preliminary was issued and we can use it. The custom is for them to say, "Well, that's all right," but they could send me a bill.

Q. Well, in that case, if that ever happened—did that ever happen to you?

A. Yes, that has happened.

Q. When that happened was it—was either the buyer or the seller charged for that preliminary report?

A. You are asking me if I can remember one specific case where a buyer or seller was charged? Yes.

Q. Who then kept that profit? It did not go back to the title company that issued the preliminary report. Who kept that? [60]

A. I misunderstood your question. I understood you to say that the company that issued the title report charged for it and was the buyer or seller charged, and if that is the case whoever was charged for it, the buyer or the seller, that fee was naturally paid to whoever issued the preliminary report.

Q. I was asking about the case where you obtained this preliminary report and you did not take the transaction back to the title company that issued the preliminary report? A. Yes.

Q. And you did not pay for that preliminary report? A. Yes.

Q. Now, in that case who kept the profit from the preliminary report?

A. In that case there would be none.

(Testimony of Dale Farnow.)

Q. You would not charge the buyer or the seller, is that right? A. That's right.

Q. How many preliminary title reports or title policies did you turn over to Bay Counties in 1952?

A. In 1952 I was Manager for Green and Kaufman and we were handling at that time an average of around 300 transactions a year. Bay Counties came in and went through our files and took such preliminaries as they wanted to use and I have no idea how many. [61]

Q. Do you know how they were paid for them?

A. At that time Green and Kaufman was not paid. We were not paid for those, to my knowledge.

Q. That was 1952? A. Correct.

Q. How about 1953?

A. I was in business for myself. I provided them with a copy of every search, provided I still had another copy for my own records.

Q. When were you in business for yourself, Mr. Farnow? A. 1953.

Q. Who with?

A. A gentleman by the name of Harry S. Brown, it was a partnership, Brown and Farnow.

Q. Were you in business in October of 1952?

A. I couldn't recall for sure.

Q. Well, I will refresh your recollection. I have a note here which says that in October, 1952, in an escrow transaction with Bay Counties Title in which the total escrow fee was \$34.50, you received \$9. Do you remember that?

(Testimony of Dale Farnow.)

A. No, I do not. If it was in October of 1952 I would presume then at that time I had already started my own business with Mr. Brown.

Q. In March of 1953 it shows you had a transaction with the Petitioner and the total escrow fee was \$498.00 and you [62] received \$124. Do you recall that?

A. No, I have no recollection whatsoever.

Q. How were you generally paid, in currency?

A. I was never paid on any one transaction at any time.

Q. Did you ever receive any money from Bay Counties Title? A. Yes.

Q. How was it paid to you? A. In cash.

Q. By whom? A. By Mr. Rolls.

Q. Would you come personally to his office or would he come to you personally or was it in the mail or in what manner was it paid?

A. No, I'd walk into his office. I conduct most of my business with the title companies by mail and I very seldom go into a title company. I would go into Bay Counties possibly once every three months at the outside, at which time Mr. Rolls would simply hand me an envelope with some cash and say that this was in payment for the searches I sent them.

Mr. Boyle: That is all.

Mr. Carey: No further questions.

Unless counsel would object, we would ask that Mr. Farnow be excused.

The Court: He hasn't finished. [63]

Mr. Boyle: That is all, your Honor.

(Testimony of Dale Farnow.)

The Court: That is all.

Mr. Carey: We will ask that he be excused unless they have some further questions.

The Court: May this witness be excused?

Mr. Boyle: Yes, your Honor.

(Witness excused.)

Mr. Carey: May we take a recess now until 2:00 o'clock before we call Mr. Rolls, or 1:30 or 1:00 o'clock?

The Court: This takes care of two witnesses. You said you were going to have four.

Mr. Carey: The other two witnesses will take a little more time. I wanted to call Mr. Rolls as my next witness.

The Court: Ordinarily I don't take two hours for lunch. I have to be finished with the trial of this case today.

Mr. Carey: Whenever you want to reconvene, it would be all right, but I would like to take the noon recess at this time, whatever length it may be.

The Court: Yes. Well, if we come back at 1:00 o'clock when will you be finished?

Mr. Carey: I would assume that we could be finished by 2:30 or 3:00 o'clock at the latest.

The Court: You would end your case? [64]

Mr. Carey: Yes, your Honor.

The Court: And are you going to call a witness? How long are you going to take with your case?

Mr. Boyle: Well, my witnesses were talking with Mr. Rogers and they have changed their testimony so——

Mr. Rogers: That is a highly improper remark, Mr. Boyle, and you know it, by inference and otherwise.

Mr. Boyle: These witnesses——

Mr. Carey: Let's have the witnesses brought into Court. There are a number of real estate brokers under subpoena by the United States. If they are not called we ask the Court to order them in. We want them as witnesses.

Mr. Boyle: Were those witnesses talking to you within the last few days?

Mr. Rogers: Not within the last few days. Wait a minute, I am not under oath. If you want to put me under oath so that this record is complete as to my conversation with those witnesses——

Mr. Boyle: Let's just find out.

Mr. Rogers: Absolutely, yes. I talk to every witness when I have a case.

Mr. Boyle: I am not going to call any witnesses. I had arranged to call them but they called me back on the phone and now I can't use them. I think it was highly unethical for them to go and talk to the witnesses. [65]

Mr. Rogers: Counsel has a right to talk to prospective witnesses.

Mr. Boyle: Yes.

Mr. Rogers: Have you talked to Mr. Compton? I have talked to Mr. Compton. We didn't call the witnesses, Mr. Boyle.

Mr. Boyle: No, I called them. That's the strange part.

Mr. Rogers: I have every right to go and talk to any witness. I will defer to the Court's judgment in this matter.

Mr. Boyle: I have no witnesses. All I will have is cross-examination of Mr. Rolls and whatever other witnesses they have, so I presume that I can finish—if they are figuring on finishing at 3:00 o'clock I could finish in two hours.

Mr. Carey: Then I will ask that the subpoenas that have been obtained by Mr. Boyle for these other real estate brokers, that the Court order these witnesses brought in because we want them on the stand. We are only producing one broker, a typical broker, if the Court please. The revenue agent in this case had a list of a number—I don't know whether he had all the brokers—so that Mr. Boyle had an opportunity to interview these people to find out whether there were any improper fee arrangements. Apparently Mr. Boyle [66] found out that there were not so he is not calling them. I think that the Court is entitled to hear these witnesses and to judge for the Court's self whether or not there was any improper tampering with witnesses as has been accused here by Mr. Boyle.

The Court: I don't know who is subpoenaed. We have a system in the Court now, under which our forms of subpoena are obtained by counsel and we don't know who has been subpoenaed. I don't have any copies of subpoenas here. Do you have any copies of subpoenas?

The Clerk: We don't keep copies any more, your Honor.

The Court: Now, if you want to subpoena any witnesses you go ahead and subpoena them. If you want to call any witnesses go ahead and call them.

Mr. Carey: Then my next witness, if it please the Court, will be Mr. Boyle, because we are going to get to the bottom of this witness tampering charge right here and now.

The Court: I don't think we are going to take time to go into that although it was very annoying to you, Mr. Carey.

Mr. Rogers: Very annoying to me, too.

The Court: To have the statement made in that way, but I am going to proceed here with this case and I am not going to take up time to go into that matter at all. [67]

I don't know who Mr. Boyle has subpoenaed and if you want to call any more witnesses this afternoon, you may do so.

It is about 12:00 o'clock and we will recess until 1:00 o'clock.

(Whereupon, the hearing in this matter was adjourned until 1:00 o'clock p.m. of the same day.) [68]

Afternoon Session

Mr. Boyle: If the Court please, at the close of this morning's session the Court asked whether the Respondent intended to call any witnesses and I stated no and then I made some gratuitous remarks

about why I did not intend to call those witnesses. I wish to have the statement stricken from the record and confined merely to the fact that the Respondent does not intend to call any witnesses.

The Court: That is a good thing to do.

Now, Mr. Carey, do you want to proceed?

Mr. Carey: Yes, your Honor. I would like to call Mr. J. M. Rolls.

The Court: Mr. Rolls.

The Clerk: He has been sworn this morning.

Whereupon,

JACK M. ROLLS

was called as a witness on behalf of the Petitioner and, having been previously duly sworn, testified as follows:

Direct Examination

Q. (By Hr. Carey): What is your present position, Mr. Rolls?

A. I am President of the Bay Counties Title Guaranty Company.

Q. How long have you been President?

A. Since its incorporation, July 3, 1946. [69]

Q. How long have you been in the title business?

A. Since October, 1935.

Q. With whom were you associated prior to the time that you became associated with Bay Counties?

A. City Title Insurance Company.

Q. All the period from 1935 to 1946, you were with City Title?

A. Yes.

(Testimony of Jack M. Rolls.)

Q. In what capacity were you employed by City Title? A. When I left?

Q. During the 11 years that you were employed there?

A. I went completely through the ropes, from the ground up to the point of being an escrow officer at the time I left.

Q. Mr. Rolls, are you familiar with the contents of a typical title plant of a typical title company?

A. Yes, I am.

Q. Would you describe to the Court of what a typical title plant consists?

A. A typical title plant consists of a gathering together of the recordings, daily recordings affecting real property, affecting the names of individuals, in turn segregating that information according to the names of individuals alphabetically in a code system perhaps as to property, segregating it individually as to particular pieces of property that are involved, and that basically is what a title [70] plant involves, together with maps and necessary paraphernalia to locate those pieces of property.

Q. Did Bay Counties Title Guaranty Company have such a title plant as of January 1, 1952?

A. Yes, we did.

Q. As of January 1, 1952, Mr. Rolls, did you have a book of abstracts and recorded instruments?

A. Yes, we did.

Q. Did you have lot books covering every lot in the City and County of San Francisco?

A. Yes, we did.

(Testimony of Jack M. Rolls.)

Q. Did you have a set of general indices?

A. Yes.

Q. What maps, if any, did you have at that time?

A. Well, they are what we call our arbitrary maps. It's for the purpose of locating the various documents that are recorded affecting real property. They covered every piece of property in the city.

Q. What tax records——

Mr. Boyle: Would you repeat that last answer? They covered every——

The Witness: Lot and parcel of property in the City and County of San Francisco.

Q. (By Mr. Carey): What tax records, if any, did you have, Mr. Rolls? [71]

A. We had traffic records of the tax office or the tax assessor's ownership records back to 1938.

Q. Would that be from 1938 to 1952?

A. To 1948.

Q. What other record or information did you have that was of value to you in title abstracting on January 1, 1952?

A. We had a complete set of Edwards Abstracts.

Your Honor, do you know what Edwards Abstracts are?

The Court: No, I don't. That is all right for you to make that inquiry. Tell us what Edwards Abstracts are.

The Witness: We might call it a magazine or a publication put out by the Recorder Printing and

(Testimony of Jack M. Rolls.)

Publishing Company, which prints each day the entire number of recordings by name, document, location of property, all of the documents that have been recorded affecting real property. They also publish the new suits that are filed involving individuals, anything to do with parties involved in legal actions, bankruptcies, Federal actions, and we had a complete set of those from 19 — well, clear back to 1908.

Q. (By Mr. Carey): Did you have any probate records?

A. This Edwards Abstracts does contain that particular information, yes.

Q. What information do you mean, in the sense of probate records? [72]

A. Going back to 1908, that is all contained in these Edwards Abstracts. Subsequent to January of 1947 we had abstracts of our own right, on our own volition or own work, the information as to divorce actions, probates, judgments, insanities.

Q. During what period of time, Mr. Rolls, had you accumulated this plant or this information that you have just described?

A. During the period of January 1947, to January 1952.

Q. During this period of time, January 1947, to January 1, 1952, accountingwise, how were the expenditures for acquiring this information treated by Bay Counties Title Guaranty.

A. They were capitalized on the basis of setting up as a title plant.

(Testimony of Jack M. Rolls.)

Q. Taxwise how were they treated?

A. Taxes were paid on the capitalization.

Q. What, if any, of these expenditures during this five-year period were taken as deductions?

A. None. May I point something out?

Q. Yes.

A. In connection with title plants, your Honor, I think Mr. Bass, just before you came in, was discussing the fact or the relationship of title insurance, and if he had enough money or anyone has enough money to obtain and qualify as a [73] title insurer in the State of California, there is no requirement under the Insurance Code that that title insurer have a title plant.

We are, as you probably have understood so far an underwritten title company. We have our own title plant which we have established. We in turn use that together with the official records of the Recorder's Office for the purpose of making searches of title. In turn, we are the authorized issuing agency for Pacific Coast Title Insurance Company and issue their policies through our office over an Assistant Secretary's signature, I being one of them and there being another one in the office, too.

I'd like to point out, though, as a prerequisite for establishing a title plant, there is none needed actually. As long as there are competent people who are doing the abstracting and searching there is no requirement under the Insurance Code that any policy of title insurance issued be based on any title plant by either the title insurer or the title com-

(Testimony of Jack M. Rolls.)

pany, so that our act of capitalizing this particular item of a title plant was voluntary on our part and also had a salutary effect against our competition in this respect, that when we first started in business they gave us six months to go and they said, "They don't have a title plant."

So we in turn capitalized that so that we could show it on our books and on our statements, that we had a [74] title plant to offset the competitive claim that we did not have a title plant, which in turn helped us in obtaining business, of course, through lending institutions. In other words, you can say that you have got a title plant but unless they see it in black and white on the financial statement they wouldn't believe it.

Q. Would it be correct to say, Mr. Rolls, that as of January 1, 1952, your records would show the record title of every piece of property in the City and County of San Francisco?

A. Generally speaking, yes. There are some pieces of property, of course, of which there are no records. Of course, they are very few and far between.

Q. For all practical purposes?

A. For all practical purposes, yes.

Q. Would it be correct to say that as of January 1, 1952, you had records to show every transaction of record affecting title to real property in the City and County of San Francisco for a period in excess of five years? A. Yes.

(Testimony of Jack M. Rolls.)

Q. Approximately how far back would those records go?

A. As I say, we had these records of the Edwards Abstract, going back to 1908.

Q. So you had in your possession information concerning every transaction of record in the City and County of San [75] Francisco back to 1908?

A. Yes.

Q. Mr. Rolls, during the years in question how much did you pay your abstractors?

A. Well, that would vary, of course, depending on how much you could get, but a good abstractor was paid about \$450 a month.

Q. Is that a 35 or 40 hour week or what?

A. It's normally a 37 and a half hour week.

Q. Mr. Rolls, would you describe the mechanics of a typical transaction going through Bay Counties?

A. First of course, the order is placed by someone, either an individual lending institution, real estate broker, and that in turn is processed by going to our tract indices, locate it as to the property, by using our arbitrary system which is assigning a lot and block number to each particular piece of property in the City and County of San Francisco, going to the information that we have on file in our card system as to this lot and block, checking to see first of all if we have a starter, your Honor, one of these preliminary reports from which we can start. Providing we do have a starter we can begin at that particular point and carry forward, obtain-

(Testimony of Jack M. Rolls.)

ing the information from our title plant, having it rechecked and verified at the Hall of Records, getting information as to the names for Court actions and matters [76] involving an individual himself that in turn affect his ownership of the real property. That information is gathered together and then is turned over to what is called an Examiner. He goes through the records that we have assembled or the searcher has assembled and renders what is called an opinion, which in turn is typed and is called a preliminary report of title.

That is sent out to the broker, the lending institution or whoever is interested in the particular piece of property. Subsequently documents are deposited in the escrow, either documents to clear the title to the property or documents for the assuming of existing loans or perhaps new loans, the deed, the seller's instructions, buyer's instructions, funds, and all of the necessary items that go to make what is called the completed and closed escrow. When that particular time occurs the documents that are to be recorded are recorded. The monies are paid out, the policy of title insurance is issued insuring the new purchaser or new lender, whichever the case may be, and the transaction is considered closed.

The Court: How many people do you have in your office here?

The Witness: We have 34.

The Court: How many Examiners and how many——

(Testimony of Jack M. Rolls.)

The Witness: We have two Examiners. We have three [77] Searchers and then our general indices, there are three in our general indices section.

Q. (By Mr. Carey): How many of these individual employees did you have when you first started in business?

A. We started out—well, when we started to write title insurance there were four of us.

The Court: And one other thing, just for the record. The Recorder to which you refer is the legal newspaper——

The Witness: As to this——

The Court: It is the Law Journal here in San Francisco.

Mr. Carey: Yes, the Recorder Printing and Publishing Company prints the Recorder, a legal newspaper.

The Court: It is the legal newspaper here like the Law Journal in New York City.

Mr. Carey: That is correct.

Q. (By Mr. Carey): Mr. Rolls, I hand you a paper. Would you tell us what that is, Mr. Rolls?

A. That is a work sheet for a preliminary report of title.

Mr. Carey: Before Mr. Rolls goes any further, I would like to have that marked as Petitioner's Exhibit 2 for [78] identification.

The Clerk: Petitioner's 2 for identification.

(Petitioner's Exhibit No. 2 was marked for identification.)

(Testimony of Jack M. Rolls.)

Q. (By Mr. Carey): Mr. Rolls, would you tell us what that consists of?

A. It consists—the outside sheet is the examiner's report, his opinion of the title.

Mr. Carey: Your Honor, I have an extra copy if you want to look at this.

The Witness: Those are photographic copies.

The Court: Go ahead.

The Witness: The outside is the examiner's opinion of the title, and the second sheet is labeled "Chain Sheet"—or I think it's torn off there, your Honor, but it's called our chain sheet which sets forth, in this particular case, a starter which we had for the TI & G, which is Title Insurance and Guaranty Report. It says restrictions, and then it says the recording of a deed to Gaugler to Walsh, a deed of trust from Walsh to the Prudential, and down at the bottom, an Incomp., Agnes Walsh, dated such-and-such a date. The second sheet, underneath that, is an abstract of the deed from Gaugler to Walsh and an abstract of the deed of trust from Gaugler to Walsh. In each case the description says "Same as TI & G report." The last item on the sheet is a copy of the Title Insurance and Guaranty Company preliminary [79] report of title, which is dated March 29, 1947.

Q. (By Mr. Carey): Mr. Rolls, from this particular document—or first of all, before I ask that question, from whence did this document come?

A. Which, you mean this?

Q. Yes, this package.

(Testimony of Jack M. Rolls.)

A. This package came from one of our files, No. 14109.

Q. From your records? A. Right.

Q. That you kept of this particular transaction.

Mr. Rolls, would you point out to the Court what, if anything, was utilized in regard to the TI & G preliminary report which is attached to that, what was done with that report?

A. It was used as a basis or a starter for the search of title, beginning, as you can see on the chain sheet, your Honor, that we started—it says at the top of the sheet, “See TI & G report,” and then the subsequent document was the document recorded by the Title Insurance and Guaranty. That’s the little notation over on the righthand column where it says, “Remarks.”

The revenue stamps were affixed to the deed and the letters “TI & G” means that the Title Insurance and Guaranty Company recorded those documents.

Q. Would you describe this as an unusual case in your office or a typical one where a preliminary report is involved?

A. It would depend on the time.

Q. Time of what, Mr. Rolls?

A. If we did not have a starter sheet or a starter preliminary report here, then we would have to go back on the records to either the date of the filed map, which according to California law is the clear—title has to be clear title as of recording of a filed map, or go back of that to 1906 which was the be-

(Testimony of Jack M. Rolls.)

ginning of our records or reestablishment of our records here in San Francisco.

The Court: Do you have the Torrens System here in San Francisco?

The Witness: No, we don't.

Mr. Rogers: Nowhere in California.

The Witness: Yes, there is the system. However, it is defunct.

Mr. Rogers: In Los Angeles they used to have it. They did have the system but now it is optional and title companies in Los Angeles have succeeded, and we had something to do with that, in trying to eliminate it. It will take ten years but it will be eliminated entirely .

The Court: I see. Just so that we get the real point of your having the witness describe Exhibit 2 for identification, now, what do you want to bring out by 2 for [81] identification? Do you want to bring out that a preliminary report was used?

Mr. Carey: Yes, your Honor.

The Court: And that preliminary report would be Title Insurance and Guaranty report?

Mr. Carey: That is correct, and further——

The Court: There is a number on the report.

Mr. Carey: Yes.

The Court: The point is: Where did they get the report?

Mr. Carey: This will come out later, your Honor.

The Court: All right.

Mr. Carey: But for the purpose here I would like to offer this as Petitioner's Exhibit No. 2.

(Testimony of Jack M. Rolls.)

The Court: If there is no objection, 2 is received in evidence.

(Petitioner's Exhibit No. 2 was received in evidence.)

The Witness: Could those copies be put in?

Mr. Carey: We would like leave to file the original and remove it and substitute a copy.

The Court: You may substitute a copy.

Is that the copy you want to withdraw?

Mr. Carey: Yes. We would like to withdraw that one and substitute another one. [82]

The Court: Let him mark the copy that you are going to give us. They are both on yellow paper so it's hard to see which is the copy.

Mr. Carey: I would like to have this one marked as Petitioner's No. 3.

The Court: Which way are you going to do it. Don't do it that way.

Mr. Boyle, supposing you look at these and see if we can have the copies offered in evidence because it takes up too much time to mark the original and substitute the copy.

Mr. Boyle: Are these all the same?

Mr. Carey: Yes.

The Court: What process do you use in making those copies?

The Witness: Those are recordak copies.

The Court: You have the originals here?

Mr. Carey: Yes, your Honor.

The Court: You can have the Clerk mark both the original and the copy, if you want to, but leave

(Testimony of Jack M. Rolls.)

with us the copy and get them both marked at the same time, and then if the Respondent wants to check them later he will have the exhibit number on the original that he can go by.

Now, you probably have two or three of those that you want to mark, one as 3 for identification?

Mr. Carey: Yes, your Honor.

The Court: With another one which would be 4 for identification?

Mr. Carey: No, your Honor. We just have the two.

The Court: Mr. Boyle can look at that now.

(Petitioner's Exhibit No. 3 was marked for identification.)

The Court: Mr. Carey, this is going to be another example of the same thing and we are going to have to take a recess for a minute. We don't have to leave the room but before we go on to 3 for identification, I want to take up a little matter that will just take a few minutes. You may step down, if you would like to, Mr. Rolls.

(Short recess.)

The Court: Just before we took the recess, counsel wanted to see Exhibit 3 marked for identification.

Mr. Carey: Yes, your Honor.

The Court: And I guess that is your own copy?

The Witness: I have mine.

The Court: All right. Will you proceed with that now?

(Testimony of Jack M. Rolls.)

Q. (By Mr. Carey): Mr. Rolls, would you describe what this Petitioner's Exhibit 3 for identification is?

A. Again this is the gathering together of the information [84] of a title search and the writing of an opinion of title by an examiner. The first page is the examiner's opinion of title. Incidentally, our file number is 12144.

The second page is the chain sheet listing the documents recorded.

Q. What, if anything, does the chain sheet show concerning any starter used by the examiner?

A. Again it shows a reference to "See TI & G policy" in this particular case.

The Court: Which is Title Insurance and Guaranty Company. Where would you have gotten that from?

The Witness: The fact that we do or did have in our file a Title Insurance and Guaranty title policy.

The Court: And you could have gotten that from your client, is that right, or how would you have gotten that?

The Witness: It would have been acquired probably from some broker or client from whom we either purchased reports or who voluntarily gave it to us.

The Court: Anything else about that?

Q. (By Mr. Carey): Mr. Rolls, would you say that this file is a typical file or is it an unusual file?

A. This is a typical file.

(Testimony of Jack M. Rolls.)

Q. Would it show a typical use or an unusual use of these preliminary reports or title insurance policies that we have been discussing? [85]

A. Shows the typical use of them.

Q. If we were to go through the Bay Counties record of transactions, would we find that in a significant number of cases, that we had starters like this and the same use has been made of them?

A. Yes.

Q. Do you recall what number of file you are now up to in your record keeping, Mr. Rolls?

A. This morning I think I took an order and the number was 37745.

Q. Does that represent separate transactions?

A. Yes, we have not skipped any numbers in our company.

Mr. Carey: Thank you. I will ask that that be admitted as Petitioner's Exhibit No. 3 in evidence.

The Court: Any objection?

Mr. Boyle: No.

The Court: There is received in evidence.

(Petitioner's Exhibit No. 3 was received in evidence.)

Mr. Carey: The clerk has the copy and we will withdraw the original.

Q. (By Mr. Carey): Mr. Rolls, I am quoting from counsel's opening statement this morning. I believe this is a verbatim quote.

"They have no means of assembling it or identifying [86] it or screening it and they can't even tell today what they did buy. All that they can say is

(Testimony of Jack M. Rolls.)

that they bought something, so we think they were still basically trying to bring in business by first making payments to the real estate broker.”

Mr. Rolls, do you have any means or technique in Bay Counties Title Guaranty Company for assembling or identifying this information that is contained on these reports? A. Yes, we do.

Q. Do you have any means in Bay Counties Title Guaranty Company for screening it?

A. Yes, we do.

Q. Are you aware, Mr. Rolls, of your own knowledge, of what you have in regard to the reports that you have bought from various people?

A. Yes, I do.

Q. Mr. Rolls, I am going to hand you a document—we are not going to admit this in evidence, your Honor,—a packet that has a number 3568-3576. Would you describe what that is, Mr. Rolls?

A. That is a file containing a group of these preliminary reports and policies of title insurance which we have acquired.

Q. Would you describe from that file the means that you have of screening that information, identifying it and making it useable at a later date?

A. Each one of these reports or policies of title [87] insurance, of course, describes a particular piece of property. Each of these reports and policies of title insurance designates an assessor's lot and block in connection with the legal description of the property. It so happens that our arbitrary system for locating the real property is similar

(Testimony of Jack M. Rolls.)

to the assessor's lot and block system. Therefore, each one of these reports is numbered. There are little numbers up in the upper right-hand corner and that's the process which is used in segregating them and putting them in proper order. It was easier to do that than have to read through. In other words, each one was gone through and numbered in pencil and subsequently segregated as to block number and lot number and then clipped together in groups of what would be more easily handled packets.

These numbers are in turn placed in our title plant, our index of properties, and we use a card system for that, and on these cards is marked a red S, which denotes on that particular card affecting that particular piece of property that we have a starter.

That card number is the same as the numbers on these reports and therefore, when we get an order for a preliminary report of title and we go and we find that that card has a red S on it we know that we have a starter report or policy for that particular piece of property, and we can then go to this file or if it happened to be Lot 35 or Lot 5 in Block 3568, [88] we have a starter for that particular lot. This would be taken out of this file and put with the order and the chain sheet and the search is completed in a particular order number.

Therefore, these will gradually go down to a point, or as we gather more of them, of course, it depends on these reports, but gradually these re-

(Testimony of Jack M. Rolls.)

ports would be transferred from this file to our current escrow file or current order file.

Q. Mr. Rolls, assuming that a transaction comes into your office and you are asked to provide a preliminary report or title insurance on a piece of property for which you do not have a starter, what then would you do to replace the information furnished by that starter?

A. That's what we call a full time search and it depends on, as I pointed out a little earlier, how far back in the records you have to go. Of course, the records in San Francisco originally started in 1906. I mean they were not originally started but they were reestablished as of 1906, as of the earthquake and fire, so that is our starting point for real property here in San Francisco.

In the event that we do not have a starter report or policy, then we have to go back to a point at which we consider is a safe point to begin. Now, that can be, as I pointed out earlier, the date of the filing of a map. The reason for that being that as of the date of recording [89] and filing of a map, the title of the property had to be clear. Therefore we know, starting at the date of filing a map, from that point on it can be continued down without any question as to the prior title having any cloud. If there is no filed map then we go back to, in many cases or most cases, back to 1906 or 1908, whenever we get the first records or changes of title in the property. So that can involve quite a bit of time.

Q. Would you have to pay a man for that work?

(Testimony of Jack M. Rolls.)

A. Yes, that involves using our searchers to do that particular work.

Q. Do you maintain, of your own knowledge, something like cost accounting in Bay Counties?

A. That's a very difficult thing to do in title insurance. I don't think there's any title insurance company in California or the United States that can come out with a true cost accounting system for the cost of a preliminary report.

Q. From your experience in the title business, Mr. Rolls, taking a typical transaction or two typical transactions, one in which you had a preliminary report or title insurance policy of two or three years ago, and one in which you did not, would it be more expensive to prepare a preliminary report—which would be the more expensive to prepare the preliminary report in the typical case? [90]

A. In the typical case, the one on which we had to go back and did not have a starter would cost more to prepare a preliminary report on that basis than the one in which we actually had a starter.

The Court: What is the difference between a starter and a preliminary report?

The Witness: They are both the same, your Honor.

Mr. Carey: I believe, your Honor, that they refer to them as a starter because they start their subsequent search at that point.

The Court: Is that right?

The Witness: That's right.

(Testimony of Jack M. Rolls.)

Q. (By Mr. Carey): Mr. Rolls, are you familiar with title practices in the City and County of San Francisco, of the title companies in San Francisco?

A. Yes, I am.

Q. I believe you testified that you were associated with the City Title Insurance Company for about eleven years, is that correct?

A. That's correct.

Q. Do you know of any arrangement for exchange of title information which the title companies in San Francisco have?

A. Yes. The other four companies in San Francisco do [91] have an agreement or an arrangement, which ever way you might call it—there's nothing in writing—it's a tacit understanding that they exchange reports, they exchange letters if indemnity, in connection with searches of property in San Francisco.

Q. Would you describe using a transaction, how this would work?

A. Well, supposing a broker or someone—an order is placed with——

Mr. Boyle: If your Honor please, I am going to object unless the witness tells from what source he derives his knowledge. If he is deriving it from hearsay, then this testimony is not permissible.

The Witness: This is not hearsay. This is from my experience when I was with City Title Insurance Company doing the searching at that particular company.

(Testimony of Jack M. Rolls.)

Mr. Boyle: But City Title is not one of the big four.

The Witness: Yes, it is, excuse me.

Mr. Boyle: I beg your pardon.

The Court: You may proceed. The objection is overruled.

The Witness: Your Honor, let me explain. There are four title insurance companies and one title company in San Francisco. We are the title company and there are four [92] title insurance companies in San Francisco.

The Court: What are the names?

The Witness: California Pacific Title Company, Western Title Insurance and Guaranty Company, formerly the Title Insurance and Guaranty Company, Northern Counties Title Insurance Company, and City Title Insurance Company. We are Bay Counties Title Guaranty Company and not an insurance company.

The Court: Go ahead.

Q. (By Mr. Carey): Would you describe the arrangement between the so-called big four for exchanging title information?

A. If Mr. Boyle would prefer, I will give an experience that I had while searching at the City Title Insurance Company.

The Court: Is this the question?

Mr. Carey: Yes.

The Witness: I was giving a hypothetical one before but——

(Testimony of Jack M. Rolls.)

Q. (By Mr. Carey): Would you give a definite one rather?

A. When I was working at the City Title Insurance in the search department, and I would be searching a piece of property on which California Pacific Title Insurance Company had had a previous recording and had issued a policy of title insurance or had made a search of title, I would in turn [93] at that particular time, in checking the records, and finding that out, would immediately send over to the California Pacific Title Insurance Company and request that they send over their run-down report and policy sheet for the issuance of a policy of title insurance and the basis of that search that we then completed at City Title Insurance Company was based on the California Pacific's report down to that particular date and they had written their policy and City Title Insurance Company then continued that down to the current date on which the particular search that I was working on was being issued.

Q. Would it be accurate to say that you as a searcher would use the California Pacific Title Report or insurance policy as a starter?

A. Yes, and that is also true of the other three companies, or in other words, California Pacific, Western Title Insurance and Guaranty Company, and Northern Counties Title Insurance Company have had the same experience with all of those, when I was down there.

(Testimony of Jack M. Rolls.)

Q. Is Bay Counties a member of that arrangement? A. It is not.

The Court: I can hardly hear your question. Will you repeat it?

Q. (By Mr. Carey): Is Bay Counties Title Guaranty Company a participant in that arrangement? [94] A. It is not.

Q. To what extent is it common practice for title companies in Northern California or generally in California, Mr. Rolls, to purchase preliminary reports to use as a starter?

A. I know this of my own knowledge, Mr. Boyle. The title companies or title insurance companies, depending on whichever happens to be starting out as a new company, have made a practice for—before I was in the business, of acquiring preliminary reports of title or starters, either from brokers, lending institutions or wherever they could be obtained. They are either obtained free or were paid for.

Q. Do you know of your own knowledge how these were treated, bookkeeping-wise, by the title companies?

A. I inquired of City Title Insurance Company in San Jose——

Mr. Boyle: I object to this as—you don't know this of your knowledge. This is based on hearsay.

Mr. Carey: I think that objection is premature. The question was: Do you know of your own knowledge how they were treated, and the answer there is yes or not and then if——

(Testimony of Jack M. Rolls.)

The Court: All right. You go along from that point.

Q. (By Mr. Carey): Do you know of your own knowledge how these were—— [95]

A. According to the other companies' books, no, I do not.

Q. So any knowledge would be simply hearsay knowledge that you had of how they told you they were treating them? A. Correct.

Q. In a typical case, Mr. Rolls, would the cost of procuring these preliminary reports represent a greater or lesser expenditure of money than would be necessary if the title in question were presently abstracted by one of your employees?

A. The purchase of preliminary reports in order to reduce the cost of searching, of course, would vary on the particular piece of property.

However, in the overall picture of operating a title company or title insurance company, being able to use preliminary reports or policies of title insurance as starters does cut down the cost tremendously.

Q. Mr. Rolls, do you know how your bookkeeping system treats, bookkeeping-wise, the expense of abstracting titles? Is it capitalized or currently expensed?

A. It is currently expensed as far as we are concerned now, because it is maintaining our plant.

Q. Do you know how your books or your tax returns reflect the cost of abstracting titles?

A. Currently? [96]

Q. Yes.

(Testimony of Jack M. Rolls.)

A. Currently as an operating expense.

Q. During the years involved, that is, during 1952, 1953, and 1954, was it your practice to buy preliminary reports or title insurance policies from any broker who had one that you wanted?

A. Yes.

Q. Did you buy them from any other people during these years? A. Yes.

Q. From whom?

A. We purchased them from a bank manager or—yes, it was a bank manager.

Mr. Boyle: What year is this?

Mr. Carey: The years involved, 1952, 1953, and 1954.

The Witness: We purchased them from—I think one was a savings and loan, for a period of time, and then they stopped the procedure.

Q. (By Mr. Carey): Are the real estate brokers in the City and County of San Francisco—which one or ones supplied you with the largest volume of business?

A. Our best client, the one who provides us with the largest, is the office of Green and Kaufmann.

Q. Have you ever bought any reports from them? A. No.

Q. Have you ever paid them any money?

A. No. Excuse me, now, may I qualify that?

Prior to this period of time we used to pay a commission. Prior to the time the law was changed, yes.

(Testimony of Jack M. Rolls.)

Q. But since the law was changed—when was the law changed, Mr. Rolls? A. In 1951.

Q. Since 1951 you have not paid Green and Kaufmann any funds of money? A. No.

The Court: How does that check with the testimony of the witness from that concern here who testified this morning?

Mr. Carey: I think the testimony would show, your Honor, that as an individual he received money, but as sales manager of Green and Kaufmann no money was ever paid to Green and Kaufmann.

The Court: That was Mr. Farnow?

Mr. Carey: That is correct.

The Court: Is there something inconsistent in this witness' testimony?

Mr. Carey: No.

The Court: Why isn't it inconsistent? [98]

Mr. Carey: Because Mr. Farnow was sales manager, according to the testimony, of Green and Kaufmann until 1952 or early 1953. He testified that while he was sales manager of Green and Kaufmann that he never—they never received any money from this Petitioner here, but after he went into his own concern, or in partnership with a Mr. Brown, that he consistently sold preliminary reports to Bay Counties and was paid for them. I think that was his testimony.

The Court: You don't deny that?

Mr. Carey: No, we don't deny that at all.

The Court: All right.

(Testimony of Jack M. Rolls.)

Q. (By Mr. Carey): Is there any reason why you have not purchased any reports from that particular broker, that is, Green and Kaufmann?

A. They did not want to sell them to us, for one thing, and they wanted to maintain their own files on them, is what it amounted to.

Q. But after refusing to sell you those reports, did their volume of business with you decline?

A. No. It increased as a matter of fact.

Q. Are there any other instances where brokers have placed business with you wherein you have not purchased reports from such brokers?

A. Yes.

Q. Are there many or few? [99]

A. There are many.

Q. To your knowledge, has the volume of business increased or decreased depending upon the fact that you did not purchase reports from them?

A. It seemed to make no difference.

Q. Are there instances, Mr. Rolls, where you purchased reports who have not furnished you with any business?

A. Yes.

Q. Can you call any of those to mind at the present time?

A. I can recall two very distinct ones because we have received so many reports.

Mr. Boyle: What year are you talking about?

Mr. Carey: We can make it any period of time from 1947 until 1954.

(Testimony of Jack M. Rolls.)

Mr. Boyle: I object to that. That will not go to the question involved here. It is immaterial and irrelevant.

Q. (By Mr. Carey): I will confine it, Mr. Rolls, to the years 1952, 1953 and 1954.

A. Yes, we did.

Q. What brokers were those, if you recall?

A. Sala & Sala, and John J. Lagorio.

Q. They furnished you no business?

A. They furnished us no business, correct.

Q. Did you buy a considerable number of reports from them? [100] A. Yes.

Q. Do you know of any other title companies in the Bay area that have the practice of buying preliminary reports? A. Yes.

Q. What other title company?

A. One that doesn't do it now, one that did do it, was Peninsula Title Guaranty Company in San Mateo County which is now City Title Insurance Company, City Title Insurance Company in San Jose in Santa Clara County. I don't think they are continuing to do it. They did do it.

Q. Did they do it since 1951? A. Oh, yes.

Q. What else?

A. The Land Title Insurance Company in Alameda has purchased reports, I think, ever since their inception.

Q. Do they continue to do so?

A. They continue to do so, although—no, I think that has been terminated by a person from whom they purchased the reports.

(Testimony of Jack M. Rolls.)

Mr. Boyle: May I have that last question and answer read?

(Question and answer read.)

Mr. Boyle: I ask that the last three answers to the last three questions be stricken on the ground that this witness is not competent to testify as to what other title [101] companies do.

The Court: You may ask him, if you want to, before you make your motion to strike.

Mr. Boyle: I move that the last three answers be stricken.

The Court: The motion to strike is denied. I have no reason to assume that he is giving hearsay testimony. You are just assuming that he is giving hearsay testimony. You have to ask a few questions to find out whether he was or not.

Mr. Boyle: I request to take the witness on voir dire.

The Court: Go ahead.

Voir Dire Examination

Q. (By Mr. Boyle): Mr. Rolls, did you work for the title companies to which you just referred?

A. No, I did not.

Q. Your knowledge then——

A. Except City Title.

Q. So therefore your knowledge of what they might be doing or have been doing would be based upon what someone told you, isn't that correct?

A. From what the owners of the company told me.

(Testimony of Jack M. Rolls.)

Q. Yes, what they told you. [102]

The Court: Is that necessarily hearsay?

Mr. Boyle: Yes, I believe it is, your Honor.

The Court: I don't know how else you would find out.

Mr. Boyle: You could bring in the owners of the other companies, if he wanted to prove that this was being done by other concerns. I don't think it would make any difference, but I do believe that it would certainly be hearsay if he is testifying to what they did because someone told him.

Mr. Carey: I think, your Honor, it is not hearsay. It particularly is as true of Mr. Boyle's interpretation of Section 12404 of the Insurance Code. These would be declarations against interest by these people. If Mr. Boyle is correct this would be confessions of a crime. They violated the Insurance Code, for which their charter could be forfeited.

Mr. Boyle: This man is attempting to testify as to the business practices of other concerns. I don't think he has shown he is qualified to do that.

The Court: I will let the answers stand.

Mr. Carey: Thank you, your Honor.

Direct Examination—(Continuing)

Q. (By Mr. Carey): Mr. Rolls, are you acquainted with any of the other agencies of the Pacific Coast Title Insurance Company in this area?

A. Yes.

(Testimony of Jack M. Rolls.)

Q. Do any of those others, those that you have mentioned in your previous answers, have they adopted this particular practice of buying preliminary reports? A. Yes.

Q. To your knowledge? A. Yes.

The Court: How do you know that?

The Witness: For one thing, by reading an ad that they have produced when they first opened.

The Court: What would they have said in their ad?

The Witness: They would reduce the cost of title policies, the cost would be reduced a certain amount—I have forgotten the exact figures—if they were furnished with either a policy—or I think they required a policy of title insurance of another title company. I also am a very close personal friend of the President of the company.

The Court: Go ahead.

Q. (By Mr. Carey): Are there any other title companies in the State of California, Los Angeles area or in any other areas of California, who adopt this same practice, to your knowledge?

A. Again it is hearsay as far as that is concerned, from the individuals, but the——

The Court: I think it is too bad you did not bring [104] in at least one witness from one of these other companies.

Mr. Carey: We did, your Honor. Mr. Smith this morning. He testified that this was the practice.

The Court: That was Elias W. Smith from the Pacific Coast Title Insurance Company?

(Testimony of Jack M. Rolls.)

Mr. Carey: Yes, your Honor.

The Court: His testimony is, according to my notes, that it was customary for them to purchase this information. From 1952 to 1954 title starters were purchased from others and preliminary reports, and I think his testimony is that they stopped doing that in 1954.

Mr. Carey: I don't know that. Mr. Boyle has limited me to testimony in 1952 to 1954. I have not attempted to go outside those three years because those are the years involved. The practices in any other years would be tending to get a little further away in point of relevancy.

The Court: All right. Go ahead. Just avoid hearsay testimony because I won't be able to give much weight to it.

Q. (By Mr. Carey): During the years in question, that is, 1952 to 1954, did you ever have occasion to discuss this particular practice of buying preliminary reports with your counsel?

A. Yes.

Q. Who was counsel for the Bay Counties Title Guaranty?

A. Mr. Joseph S. Rogers. [105]

Q. Did this discussion concern whether this practice violated any law of the State of California?

A. Yes, it did.

Q. Did he advise you that it did or did not violate any law?

A. He advised us that it did not.

The Court: What is the attorney's name?

Mr. Carey: Joseph S. Rogers.

(Testimony of Jack M. Rolls.)

The Court: He is here in the court room?

Mr. Carey: He is here in the court room.

Q. (By Mr. Carey): Did he give anything other than his own opinion concerning the legality of these transactions, Mr. Rolls?

A. Subsequently we acquired a written opinion from the Legislative Council of the State of California with respect to the legality of this particular practice in connection with purchase of preliminary reports.

Mr. Carey: I would like to have this marked, if the Court please, as Petitioner's next in order.

The Clerk: Four for identification.

(Petitioner's Exhibit No. 4 was marked for identification.)

Q. (By Mr. Carey): Mr. Rolls, I hand you Petitioner's Exhibit 4 for identification and ask you: Is that the opinion that you [106] have reference to? A. Yes.

The Court: Who gave that opinion?

The Witness: Ralph N. Kleps, Legislative Counsel, by Bernard Czesla, and it is dated October 27, 1953.

The Court: And it is addressed to——

The Witness: Honorable John F. Thompson, Route 3, Box 408, San Jose.

The Court: Who is he or was he?

The Witness: State Senator.

Q. (By Mr. Carey): You came in possession of this particular opinion, Mr. Rolls, through the medium of your counsel, is that correct?

(Testimony of Jack M. Rolls.)

A. Yes.

The Court: Respondent has already seen that, it was attached to the application to take a deposition.

Q. (By Mr. Carey): And are you familiar with the contents of that ruling? A. Yes.

Q. Did Bay Counties Guaranty Company attempt to bring its conduct in the years in question within the terms of that ruling? A. Yes.

The Court: How or why or both? Your answer won't mean very much to me in reading the record unless you explain [107] it.

The Witness: Well, I think—may I read this opinion and then explain how we complied with it?

The Court: Yes, you have read it before, of course, have you not?

The Witness: Yes.

The Court: You want to refresh your recollection?

The Witness: That's right.

The Court: All right. Look it over.

The Witness: Well, it's on page three, your Honor, the section at the top of the page: "There is therefore no statutory reason why an insurer may not purchase a copy of the old title insurance policy for the specific property and issue a new policy of title insurance relying in whole or in part upon the facts contained in the former policy, as long as the cost of purchasing such policy is included in the charges for the new policy as required by Section 12401 to 12412.

(Testimony of Jack M. Rolls.)

“While this practice of purchasing copies of title insurance policies generally would not be violative of any statutory provision, the question arises as to whether such a purchase, if made from a real estate broker who was the agent of one of the principals in the transaction with which the title insurance is sought, would be violative of the statutory provisions prohibiting the payment of commissions and rebates.” [108]

It goes on to the end of the letter and it says: “The payments here in question do not meet this definition.” This refers to the rebate mentioned previously, and “Payments are not made to the policy holder and cannot be said to constitute an abatement or remission of any part of the fee to such policy holder. The payment is made to the broker because the broker has a document of value to the insurer which he delivers to the insurer, not because the broker is an agent of one of the principals in the transaction in connection with which the title insurance is sought. Presumably the payments are made to any party who can supply documents upon which the insurer may rely in issuing a policy of title insurance.”

In our practice in purchasing these reports, we did not require that it be in connection with any particular record title that we were asked to issue at that particular time, but we bought for all property in San Francisco regardless. As a matter of fact, the more that we could get the better we liked it. We were certain that as far as any particular

(Testimony of Jack M. Rolls.)

transaction was involved, that there was no payment for any that could be considered as a rebate or a commission or any thing that would be contrary to the law.

The Court: Well, now, the thing this Court is going to have to decide in this case is whether the expenditure for one of these copies of a preliminary report must be [109] capitalized or whether it can be expensed and in considering that question we will be obliged to apply general principles.

Now, you have just stated that you did have a practice of acquiring these preliminary reports whenever you could find them. Then you would keep them in your files and you expected that perhaps at some future time it would be useful to you?

The Witness: That's correct.

The Court: Now supposing you paid \$50 for a preliminary report in 1946 but had no use for it at that time and it wasn't until 1956 that you really had use for that preliminary report. There the expenditure was made in 1946, we will say, but you didn't use the item until 10 years later.

Now, the question would be: Why isn't that the kind of expense that you should capitalize? You are not using up the item that you made the expenditure for in the taxable year. That is the principle on which you expense items, is that you are using up the item. It isn't an item that has any useful life to you over a period of years. If you make an expenditure for something that is going

(Testimony of Jack M. Rolls.)

to have a useful life over a period of years, then you must capitalize it.

So in your business it might be that some of these expenditures would be properly expensed. If you are going to handle an escrow in 1952 for a piece of property located [110] on the corner of Geary and Stockton Street and you obtain at that time a copy of a preliminary report. You use it for that transaction, which you work on in 19—I have forgotten the date.

Mr. Boyle: 1952, 1953 and 1954.

The Court: I may have taken 1953 as the year.

You pay \$50 in 1953 for a preliminary report on the piece of property at the corner of Geary and Stockton Street, but you use it right away in that transaction and you are paid for your services in 1953 and the transaction, as far as you are concerned is closed in 1953 and you pay out some expenses in connection with that transaction. Now, all those expenses you would offset against that income if the thing has been used in the taxable year. You made use of this preliminary report in the taxable year in connection with the particular transaction. All right. You expense that.

But if you were going to purchase these preliminary reports for searches of title, parcels or pieces of property here, there and everywhere throughout San Francisco, wherever you can get them, and put them in your files or library until such future time as you make use of them, then it would seem that you have there an expense that should be capitalized.

(Testimony of Jack M. Rolls.)

What are you going to do about that?

Mr. Carey: If the Court please, it has been recognized by the Internal Revenue Service since 1921 as set [111] forth in OD No. 1,018, which is filed at 5 Cumulative Bulletin, Page 119, and I am quoting this OD.

The Court: What is that, Roman numeral 5?

Mr. Carey: No, it is 5 CB Page 119.

The Court: Part 1 or Part 2?

Mr. Carey: I think at that time it was all one volume, and I am quoting from that:

“Title abstract companies incur relatively large and continuous expenditures in keeping their plants up to date, such as the expense of adding and incorporating in the plant records that are being made daily in the various Courts and in the Recorder’s Office. These records which are added to and incorporated in the plant for the purpose of keeping it in an up-to-date running order and preventing depreciation, are in the nature of ordinary and necessary repairs. The expenses therefore incurred in making such records are current expenses and as such are deductible for the year in which paid or incurred.”

The Court: You are relying on that Office Decision?

Mr. Carey: That is correct. That is the practice, this is the reality of the business.

The Court: Why did the Commissioner make this determination in this case?

(Testimony of Jack M. Rolls.)

Mr. Carey: If your Honor will look at the 90-day letter, the capital expenditure idea is an afterthought. It [112] is not the principal ground on which they rely. They started out believing that we had violated the Insurance Code of the State of California and this is in the 90-day letter.

The Court: What is your next question?

Q. (By Mr. Carey): To your knowledge, Mr. Rolls, have any charges ever been placed against any title company by the Insurance Commissioner because of the practice of purchasing preliminary reports? A. No.

Q. Have any charges ever been placed against Bay Counties? A. No.

Q. Did you purchase any preliminary reports in the years in question from a McPhee Realty Company? A. Yes.

Q. What company is that? Who owned the McPhee Realty Company at that time?

A. Chester McPhee.

Q. Who is Chester McPhee?

A. He is the past Collector of Customs and is presently the Chief Administrative Officer of the City and County of San Francisco.

Q. Mr. Rolls, in 1952, how much, if anything, did you pay real estate brokers for the purchase of these preliminary [113] reports? A. 1952?

Q. Yes. A. \$6,896.

Q. How did you treat that in your tax return?

A. In 1952 that amount, as I recall, was charged off as advertising expense.

(Testimony of Jack M. Rolls.)

Q. In 1953, how much, if anything, did you pay to real estate brokers for the purchase of these reports? A. \$8,581.

Q. How did you treat that in your income tax return? A. As advertising expense.

Q. In 1954 how much, if anything, did you pay real estate brokers to purchase these preliminary reports? A. \$7,534.

Q. How did you treat that in your tax return?

A. Again as an advertising expense.

Q. Mr. Rolls, was there any reason for treating this as advertising expenses in your tax return?

A. Yes.

Q. What was that reason?

A. We had applied in 1951, I think it was, for a refund against a loss. In other words,—

Q. A carry back refund?

A. Yes, and at that particular time, on that application [114] for a refund for carryback loss, our books were audited or checked by the Internal Revenue at that particular time.

I think it was a Mr. Kewman—K-e-w-m-a-n—I think it was, was the gentleman who checked our books at that particular time. Prior—I forget what date it was—in 1952, we had been charging that item as a plant expense, operating expense. In the dicussion with Mr. Kewman he asked about it and he said, “Well, I think that rather than charging it to plant expense, you should charge it to advertising.” That’s why we changed from charging it to plant expense to advertising expense.

(Testimony of Jack M. Rolls.)

Mr. Carey: Thank you, Mr. Rolls. I have no further questions.

Cross Examination

Q. (By Mr. Boyle): Mr. Rolls, as I understand it, you started business with Bay Counties in January of 1947. Is that correct?

A. No, I started with the incorporation of it in July of 1946.

Q. When did you start business?

A. Actually open the doors?

Q. Yes. A. In September, 1946.

Q. From September, 1946, until about September of 1951, did you have a practice of paying ten percent of the escrow [115] fee and title insurance fee to real estate brokers who brought business to Bay Counties?

Mr. Carey: I object. I don't know what relevance it has. It has been brought out here that the statute permitted this up until 1951. What relevance will it have from that period on? The fact that he complied with the law when it was lawful to pay commissions does not have any effect upon what he did after it was unlawful to pay commissions.

The Court: What is the relevance?

Mr. Boyle: What they were doing after 1951 was the same as before. The record will show continuation of the old practice. We think the picture presented to the Court will then be clear and distinct as to what the whole transaction was.

(Testimony of Jack M. Rolls.)

The Court: The objection is overruled.

Answer the question and then I am going to take a recess for a few minutes.

The Witness: Where were we again?

(Question read.)

A. I don't recall that it was 10 percent but we did pay a commission to brokers for bringing business to our office, yes.

The Court: Step down, please. We will resume in a few minutes. [116]

(Short recess.)

Q. (By Mr. Boyle): Mr. Rolls, would you pay this commission to these real estate——

Mr. Carey: I object to the use of the word "commission." If he wants to use "sum of money" that is fine. We have contended and we are not going to permit questions which use the word "commission". That is an attempt to trip this witness and attempt to show that this witness is violating the law by paying a commission.

Mr. Boyle: That is agreeable. I will change the word.

Q. (By Mr. Boyle): Mr. Rolls, in making these payments to the real estate brokers prior to 1951, did you do so without regard to whether or not you received a preliminary title report or title policy?

A. Yes, although we requested that—we asked the brokers from the time we started writing title insurance that we be furnished wherever possible preliminary reports or policies of title insurance.

(Testimony of Jack M. Rolls.)

Q. You asked them for one but if they did not have one, you made the payment to the broker anyway? A. That is prior to 1951?

Q. Yes, prior to 1951. Is that correct? [117]

A. Yes.

Q. Did you acquire the idea of buying these reports from a title company in San Mateo?

A. Yes.

Q. And that was the result of the law being passed in 1951? A. No.

Q. When did you change your system, as you state, from making payments to the brokers without regard to title reports?

Let me ask you this, Mr. Rolls, is your system any different today or during the years involved herein, 1952, 1953 and 1954, from the system you followed prior to 1951 as concerns payments to real estate brokers? A. Yes.

Q. It is different? A. Yes.

Q. In what way is it different?

A. We were purchasing more reports in 1952, 1953 and 1954, as a matter of fact. We made a concerted effort to obtain reports from brokers.

Q. Were these preliminary title reports or title policies any more valuable to you in 1952, 1953 and 1954 than they were before 1951?

A. Relative values are always the same regardless. [118]

Q. I believe your records show that Bay Counties had a bank account in 1952, 1953 and 1954?

(Testimony of Jack M. Rolls.)

That is, you had a checking account from which you drew checks, is that correct? A. Yes.

Q. And you made payments of certain expenses by check, is that right? A. Yes.

Q. Why did you not make these payments to the real estate brokers also by check?

A. It was simpler to make it by cash, as far as the bookkeeping entries were concerned.

Q. So far as the bookkeeping entries were concerned, that took two entries, did it not, a check to Buy Counties Title which you cashed and then took the cash and made the payment to the brokers. Is that right?

Mr. Carey: I object. That is argumentative, your Honor.

The Court: Objection overruled.

The Witness: May I have that question again, just to get it read?

The Court: Read the question.

(Question read.)

The Witness: There were not two bookkeeping entries, only one. [119]

Q. (By Mr. Boyle): Also you had to make an entry showing this was an advertising expense, did you not?

A. That was done in one item, as far as the cashing of that check was concerned, one entry.

Q. How did you make the payment in currency to these brokers? Did you do that personally or by mail? A. Personally.

Q. Did you go to their place of business?

(Testimony of Jack M. Rolls.)

A. Sometimes.

Q. How much did you generally pay for a preliminary title report or a title insurance policy?

A. It varied.

Q. On what would you base your estimate of that value?

A. Might I explain it this way?

The Court: Do you mean on what did they base the amount that was paid?

Mr. Boyle: Yes.

The Witness: Your Honor, might I explain it this way?

In a majority of the offices to whom we paid money for reports, the discussion as to the payment for reports and the obtaining of those reports was handled usually with the owner of the office, the purpose being, of course, that those [120] are their personal files where those reports or policies are filed. That request would be made of them, if possible that either myself or someone from our employ, a trusted employee, could go through their files and pull the reports from their files and in turn take them to our office for our use. There were innumerable offices where the number of reports that were pulled were in the thousands, so that the basis of payment that was arrived at for those, in most cases, was the fact that when they gave us business we in turn would pay them a certain amount. If they did not give us business and they wanted cash for those reports, we would arrange to pay them cash over a period of time.

(Testimony of Jack M. Rolls.)

Q. (By Mr. Boyle): Did you make payments to any brokers in 1952, 1953 and 1954 where they did not bring you business? A. Yes.

Q. Did you record those payments and claim them as advertising expense? A. Yes.

Q. Will your books and records show that?

A. I don't know. They will show a cash payment and that's about it.

Q. Are you saying that your books will show this or won't show this?

A. They will show an amount of cash drawn, yes. [121]

Q. Will it show a payment to a broker?

A. No.

Q. Charged as advertising expense?

A. No. It will merely show the report costs and charged to advertising.

Q. It will show a charge to advertising expense?

A. Yes.

Q. What record will show that?

A. The entries in our daily ledger which you looked at before.

Q. Mr. Rolls, I am not trying to confuse you, but I believe that entries in the daily ledger will show payments to real estate brokers in a certain amount and if you total all those amounts it will come to the amount of advertising that you claimed in each year and on which you took a deduction.

Now, I am asking you: Are there any other payments made to brokers which are not included in

(Testimony of Jack M. Rolls.)

those amounts of advertising that we have discussed before and you mentioned the amounts?

A. No, they are all included in the figures there.

Q. Then, in other words, whatever payments you made to real estate brokers in 1952, 1953 and 1954 will be reflected in the broker account, is that right?

A. Some of those will not show the broker to whom we [122] made the payment, where we did not get business from them, or, in other words, those are not—excuse me, you are getting a daily ledger sheet confused with those. Those are our daily ledger sheets. These others are merely a personal record of the volume of business received from all real estate offices.

Q. Now, you have said the amounts that you paid to these individual brokers did bear a relationship to the amount of the escrow fee involved in the transaction which they later brought in. Is that correct?

A. The only basis on that was the fact that we received a certain amount of business from them and in turn had agreed to purchase reports or had received reports from them for which we were going to pay them and depending on the number of reports which we received, they received payment spread over a period of time.

Q. Was there a relationship between the amount you paid the broker and the amount of the escrow fee?

Mr. Carey: I object to that on the grounds that if he is asking what the records will show, that the

(Testimony of Jack M. Rolls.)

records would be the best evidence of that fact and this witness should not be requested to recall every entry in his books to show what these records would show in the amount of relationship.

Mr. Boyle: I am asking for this witness's [123] understanding of the matter.

Q. (By Mr. Boyle): Do you understand that there was a relationship?

A. There might have been, yes, but it was not too definite.

Q. Would this relationship exist irrespective of the number of preliminary reports or title policies that might exchange hands?

A. No, not necessarily.

Q. In other words, were you paying these brokers on the basis of valuing each specific report or policy?

A. I would say on the number that they gave us.

Q. Then my next question is the same as before. There was no connection between the amount paid and the number of reports that you received, is that correct?

A. Yes.

Q. What was that connection?

A. Well, as I say, in one office we picked up about 5,000 reports, a little over 5,000 reports.

Q. What did you pay for those 5,000 reports?

Mr. Carey: If you recall.

The Witness: I don't recall.

Q. (By Mr. Boyle): Take another office in which you supposedly bought five reports. On what

(Testimony of Jack M. Rolls.)

would you base your estimate of value [124] on the five? A. I don't know.

Q. In other words, you do not recall and you were the buyer of these reports, you do not recall ever putting a value on a single report as such. Is that correct?

A. Oh, yes. I have put a value on a single report or a policy.

Q. I am asking you for that. What value did you put on any one?

A. I don't recall the exact value right now on a particular transaction.

Q. You do not recall the exact value of any report, is that right?

A. The exact value—I know that there are or there has been exact values put on some reports, yes.

Q. What was your mental computation that you went through in arriving at a value, if you do not recall the specific figure, what was your method of putting a value on a report or a number of reports?

A. The location of the property within the City and County of San Francisco. There were certain areas in San Francisco which the background of titles is quite complicated and reports or title starter reports or policies within those certain areas are more or less invaluable, as far as that value to us is concerned because they contain information which [125] is difficult to obtain.

Q. Then you are telling the Court that these records will not show any definite percentage, if

(Testimony of Jack M. Rolls.)

the amount paid to the broker is related to the escrow fee? A. I didn't say that.

Q. Do you think there will be a percentage relationship?

Mr. Carey: I object. He is asking what he thinks and the records will show that and the best evidence rule says that it should be obtained from the records themselves, not from this witness.

Mr. Boyle: Now, the witness is testifying, your Honor, that he placed a value on each specific report and I am asking him——

Mr. Carey: The witness did not so testify and the question was asked several times. The witness was asked what the mechanics of valuing particular reports were and he explained what he went through to arrive at a value.

Q. (By Mr. Boyle): Do you think there is a connection between the amount paid the individual broker and the amount of the escrow fee of the business brought in by that broker?

Mr. Carey: I object to that on the ground that the best evidence rule, your Honor,—the records are available. If counsel wants to put them in evidence to show a relationship, he has every privilege of doing so but that is a matter [126] of proving the records.

The Court: The objection is overruled. The witness is the head of a business. He owns the business and he ought to know what his general procedure is and I would think that his knowledge would be the best evidence.

(Testimony of Jack M. Rolls.)

Q. (By Mr. Boyle): Did you keep a business record of these broker accounts?

A. Now, do you mean by a "business record" a ledger, a regular bookkeeping entry?

Q. Yes. A. No.

Q. Do you have an account here in Court which will show the escrow transactions with specific brokers and the amounts paid to those brokers?

A. It will show all brokers that we dealt with during a period of a month.

Mr. Boyle: May I have that set of records?

I will ask that this be marked for identification as the Respondent's next in order.

The Clerk: E for identification.

(Respondent's Exhibit E was marked for identification.)

The Court: What was 4 for identification? It hasn't been received in evidence. [127]

Mr. Carey: Not yet.

The Court: Are you going to offer it later?

Mr. Carey: I will offer it later, that is right.

The Court: What is it?

Mr. Carey: It is the opinion of the Legislative Counsel concerning the interpretation of Section 12404 of the Insurance Code.

The Court: Go ahead.

Mr. Carey: We will stipulate that those can be admitted into evidence as having been prepared by Mr. Rolls and kept by Mr. Rolls.

The Court: I find that arrangement very troublesome later. Then the Court is given the job of

(Testimony of Jack M. Rolls.)

trying to read the record and even if you are willing to stipulate that that can be admitted in evidence the Court will have to have testimony about it. I think you ought to proceed in the usual way. Don't be thrown off your course by that offer to stipulate. Go ahead.

Mr. Boyle: I merely wanted to put them in evidence and then question the witness.

The Court: Get it identified for the record so I know what it is. I don't know what it is and the record won't show what it is.

Q. (By Mr. Boyle): I show you Respondent's Exhibit E for identification [128] and this consists of some 20 pages running from the month of January, 1952, through December of 1954. I ask you if that is the broker account to which you just referred?

A. That is correct. This is my personal record, broker account record.

Q. Directing your attention specifically to the first page which contains entries for the month of January and February, 1952—

The Court: It isn't in evidence yet. Before you offer it in evidence you have got to find out what it is. He said that those are his personal records. They are yellow sheets of paper and they don't seem to have come out of any accounting book.

The Witness: They did not, your Honor.

The Court: Who maintained those records?

The Witness: I did, your Honor.

The Court: You kept them in your office?

(Testimony of Jack M. Rolls.)

The Witness: Yes, your Honor.

The Court: But they are records in connection—maintained in connection with this business, is that correct?

The Witness: With the volume of business received from brokers.

The Court: And is there any other account in the company's books relating to the business with brokers?

The Witness: I have what is called a little black [129] book which also has records as to brokers.

Q. (By Mr. Boyle): But there are no payments in that book, are there, no figures?

A. There are no figures. Well, there are figures as to numbers of transactions, yes.

Q. But Exhibit E for identification is the record which will directly relate to the issue before this Court, namely, the so-called advertising expenses that were deducted and which were made up of payments to real estate brokers in the years involved. Is that correct? A. Yes.

The Court: All right. Offer it.

Mr. Boyle: I offer in evidence Respondent's Exhibit E for identification.

Mr. Carey: No objection.

The Court: Without objection, Exhibit E is received in evidence.

(Respondent's Exhibit E was received in evidence.)

Mr. Boyle: I ask permission to withdraw this and submit photostats, if they can be made.

(Testimony of Jack M. Rolls.)

The Court: Yes.

Mr. Boyle: It is also understood that the parties will attempt to put in some schedule *form* this information. [130]

Mr. Carey: That is agreed.

The Court: That is going to be required by the Court.

Mr. Carey: The parties have discussed this and we will attempt to do it satisfactorily to all parties and do it before the Court leaves this session.

Q. (By Mr. Boyle): Mr. Rolls, I show you Respondent's Exhibit E and direct your attention to the page which contains entries for January and February, 1952, and I will ask you to state what information is contained on any particular line of that page. For instance, the first line is—skip that and let's take line 4. "Earl Realty." Do you see that? A. Yes.

Q. Now, was Earl Realty a broker, a real estate broker?

A. Real estate brokerage firm, yes.

Q. Now, I notice some figures in black ink. What do those represent, the first set of figures after the name "Earl Realty" in black ink? What are those?

A. Those are amounts involved in transactions that were closed by that particular office.

Q. Then the next figure is red, figure \$452.75. What does that represent?

A. That represents—without adding it again—it should represent the total, I think. [131]

(Testimony of Jack M. Rolls.)

Q. It should represent the total of the black figures? A. I think so.

Q. Then underneath that is the figure \$113 in red and also circled with a red pencil. What is that figure?

A. That was the amount that was paid to the real estate office for the reports.

Q. To Earl Realty? A. Yes.

Q. And at that time?

A. Well, it might not have been paid in January. It might have been paid in March or April or something.

Q. Now, a similar set of figures in black ink and red ink follows most or at least a great number of the names on this sheet. If I asked you the same questions, would your testimony be the same with regard to those figures?

A. I think it would be, yes.

The Court: This relates to the taxable year?

Mr. Boyle: 1952.

The Court: One of the taxable years and the Petitioner admits making certain payments, isn't that correct?

The Witness: Yes, your Honor.

The Court: The total amounts that are involved in this case are admitted to have been made by the Petitioner?

Mr. Carey: That is correct.

The Court: The question is to determine [132] what the nature of those payments is, for one thing,

(Testimony of Jack M. Rolls.)

and two: whether they can be capitalized or expensed. That is the way our issue has shaped up.

Mr. Carey: Yes, your Honor.

The Court: Now, you have this record. Let me ask you this question: Am I to understand that we obtain from Exhibit E the individual payments which aggregate the total amount involved in each one of the taxable years in this case?

Mr. Boyle: Yes, your Honor. That is my understanding.

The Court: Have you ever added them up?

Mr. Boyle: The revenue agent has and he says that they will total out. He is here in court.

The Court: Well, now, did the revenue agent in making his audit and writing up his report take figures that were charged to advertising expense from other ledger sheets than this particular record which is now Exhibit E?

Mr. Boyle: No, your Honor. That report contains no reference to any other, if any, so-called advertising expenses.

The Court: Well, I understand that Exhibit E shows amounts that were paid to brokers. Is that right, Mr. Rolls?

The Witness: Yes, your Honor. It shows certain amounts were paid to brokers. In other words, this is a record of what business was received from brokers. Some were [133] paid for preliminary reports and others were not.

The Court: Well, then, it shows in the instances where payments were made, it shows them?

(Testimony of Jack M. Rolls.)

The Witness: Yes.

The Court: It shows that they were made and you have said that all of those payments were charged to advertising expense?

The Witness: Yes, your Honor.

The Court: Well, the record which you have in front of you, Exhibit E, is not a record maintained in an accounting book?

The Witness: No, your Honor.

The Court: Whereas an account for advertising expenses is an account which you maintained in an accounting book. Well, now, are these figures of payments to brokers which are shown on Exhibit E entered somewhere in the regular books as accounting expense?

The Witness: Merely the total, your Honor.

The Court: Total for what?

The Witness: The total amount paid.

The Court: For the month, year or what?

The Witness: For the month, each month.

The Court: For each month. Well, do you have here then the advertising expenditures account?

Mr. Carey: Yes, your Honor. These are the daily ledger sheets. [134]

The Court: Now, those are daily ledger sheets.

Mr. Carey: It is a single entry bookkeeping system.

The Court: Would Mr. Rolls's statement be correct that we would find one figure there as a monthly figure?

(Testimony of Jack M. Rolls.)

Mr. Carey: Yes, your Honor. There would be one figure for the month and a typical month which would be drawn to cash or to Bay Counties Title Guaranty Company, which would be labeled.

The Witness: I think on that particular one, it goes over to the next, in February.

The Court: Then I think we ought to have the ledger sheets marked for identification as Exhibit F so that we can get a few examples where we traced this matter from the work sheet record to the accounting record.

Mr. Boyle: Possibly I can obviate this if I ask the witness this question.

Q. (By Mr. Boyle): These daily ledger sheets, just referred to, will only show a check drawn to Bay Counties Title Company, will they not?

A. That's correct.

Q. They will not and that entry was prepared after Respondent's Exhibit E?

A. Was totaled.

Q. Was totaled, yes, and therefore the daily [135] ledger sheets will not really add anything other than show the amounts paid to brokers were paid in cash.

The Court: They will show the way it was done.

Mr. Carey: I think, your Honor, that they will, and if Respondent does not offer them—I am out of order—but I would be happy to offer them as Petitioner's next in order with permission to withdraw them and prepare summaries.

(Testimony of Jack M. Rolls.)

The Court: I will accept them as Petitioner's offer. That would be Exhibit 5 and it is received in evidence.

(Petitioner's Exhibit No. 5 was marked for identification and received in evidence.)

Mr. Carey: There are three groups of ledger sheets.

The Court: For the taxable years?

Mr. Carey: For the three taxable years.

The first one is denominated "Photographic and Plant Expense." The second one is "Advertising and Entertainment," and the third one "Advertising and Entertainment," on the top sheets and we will prepare summaries which Respondent may have every opportunity to check against the original records and ask that this summary from these be Petitioner's next in order.

The Court: It will be made part of Exhibit 5, I think.

Mr. Carey: Thank you, your Honor. [136]

Q. (By Mr. Boyle): Mr. Rolls, Respondent's Exhibit E consists of 20 pages running from January, 1952, through December, 1954. If questions put to you with regard to what appears on each page were the same as were put to you with regard to the first page for the months of January and February of 1952, would your answers be the same as they were in explaining what these pages contain?

(Testimony of Jack M. Rolls.)

A. Yes, I think they would. I haven't looked at them thoroughly, each one, but I presume that each one discloses the same information.

Q. Does Bay Counties Title and Insurance Company have any record—

Mr. Carey: I object to that. There is no such company as Bay Counties Title and Insurance Company.

The Court: Do you want to change it to the Petitioner?

Mr. Boyle: Yes.

Q. (By Mr. Boyle): Does the Petitioner have any record which will show the specific title reports or title insurance policies purchased from any particular broker? A. No.

Q. There is no record in existence which will show from whom any particular title report or title insurance [137] policy was purchased, is that correct?

A. Other than the reference in each preliminary report to whom it is addressed and even that might not be correct as to from whom it was received.

Q. How many of these preliminary reports or policies did Bay Counties purchase in 1952?

A. I really don't know. I don't recall.

Q. In 1953 or 1954?

A. I don't recall any of the years. Of course, it's been accumulated over a period of time and it would be a problem of segregating them and all.

(Testimony of Jack M. Rolls.)

They pile up to a point and then they go through them so there's really no way to say.

Q. Approximately how many escrow transactions did the Petitioner handle in 1952?

Mr. Carey: I object to that on the grounds that the records will show that.

Exhibit E in evidence, it has been testified, would show every escrow that was handled in each month of 1952, 1953 and 1954.

The Court: Is that what Exhibit E will show?

Mr. Carey: From every source, is that correct?

The Witness: Not necessarily. That is merely a record of real estate transactions. We handle accommodation escrows and other escrows, so the volume of orders that you [138] are talking about would not coincide with that either, you see, and I couldn't give you those figures because I'd have to go back and check the books.

Q. (By Mr. Boyle): As a general rule, did the title report or title policy which you acquired relate to the property involved in the specific transaction or escrow transaction being handled at that time?

A. Sometimes yes, sometimes no. I mean it is, as I say—we requested and have always done it up to—we still try to get them but we don't make as concerted an effort due to the fact that we have acquired so many of them over a period of time.

Q. Would you say that the bulk of the reports and policies you have acquired or did acquire in the years before the Court, would you say that the

(Testimony of Jack M. Rolls.)

bulk of those did not relate to any specific escrow transaction? A. Oh, yes.

Q. You would say that they did not relate?

A. Did not relate.

Q. If this particular report or policy did not relate, how did you know that you were not buying a duplicate of something you already had?

A. We could have bought duplicates. However, you see, the peculiar thing is this: That merely adds strength to the [139] records that you already have. In other words, if you have a record or report dated in 1948 from California Pacific Title Insurance Company and subsequently we get a duplicate report from—or a policy, from City Title Insurance dated in 1953, true, there is a duplication. However, there is a gap in there which they have covered and it merely brought our plant more current, you see.

Your Honor, can I do a little explaining in connection with these reports? I think what you are getting at——

Mr. Boyle: Unless your Honor wants it, I am finished. Unless you want him to go ahead, I would just as soon go on.

The Court: Can you make a note of what you want to explain and perhaps go into it later. This is cross-examination and ordinarily we think it is not a good idea for a witness to volunteer anything at any time but particularly not when he is being cross-examined.

The Witness: I see.

(Testimony of Jack M. Rolls.)

Q. (By Mr. Boyle): Now, in a case where you buy a report or a policy which is not involved in a pending escrow, is it possible that that particular report or policy might not be used until 1975 or 1980? Is that possible? A. It is possible.

Q. And it is possible, too, that it may never be used in the lifetime of your company. Isn't that possible? [140]

A. Depending on what our volume of business is, yes.

Q. How many pieces of property do you understand there are in the City and County of San Francisco?

Mr. Carey: I object to that. I think that has no relevancy to this proceeding in any way, shape or form.

The Court: Objection overruled.

A. That would be merely a guess. I couldn't even hazard a guess.

Mr. Boyle: I will supply the information. They have on the real estate, there are approximately 157,000 separate parcels or lots.

Mr. Carey: If counsel is testifying now I request he be put under oath.

The Court: I can't pay any attention to statements made by counsel. I can't make any finding of fact based on statements made by counsel.

Q. (By Mr. Boyle): Mr. Rolls, did Bay Counties have a title report or title policy on every lot in the City and County of San Francisco in 1952?

A. No.

(Testimony of Jack M. Rolls.)

Q. 1953? A. No.

Q. In 1954?

A. No. [141]

May I understand that question to be sure that my answer was correct? You asked if Bay Counties Guaranty Company had either a report or policy of title insurance on every piece of property in the City and County. No. That is correct, it did not.

Q. Now, on direct examination some point was made about the fact that Petitioner had a record of the record owner of every piece of property in the City and County of San Francisco. Was that the testimony? A. Yes.

Q. Was that the answer? A. Yes.

Q. But that information did not enable you to show that the record owner had good title, did it?

A. It might, yes.

Q. By knowing the person in whose name the property rests, is that sufficient to show that he has good title?

A. Your Honor, excuse me. To get into a complete discussion of how a title insurance company operates, it would take a long, long time and the basis on which reports are made. Yours is a question which becomes quite involved. I could go in and explain the procedure.

Q. From some place in the petitioner's books and records, you know who is the record owner of each piece of property, isn't that what you testified to? [142] A. Yes.

(Testimony of Jack M. Rolls.)

Q. Could you recommend the issuance of a title insurance policy on that information alone?

A. Oh, no.

Q. No, you could not?

A. No. Or, excuse me. If you wanted to, you could. A prudent——

Q. You do not?

A. ——company insuring titles does not do that.

Q. What additional information is necessary to issue a title insurance policy?

A. A complete search of the records affecting the particular piece of property involved, together with the search of the records of the ownership so the individuals who have had ownership of that property over a period of years and examination of all of those documents, instruments, that affect——

Q. That is called abstracting the title, is it?

A. That is abstracting it. It can be, if an abstract is made of each document, yes.

Abstracting is making a copy of each recorded document.

Q. And then searching?

A. No, the searching is locating the documents and abstracting is copying those documents. [143]

Q. What do you call the opinion that the title is good down to the last grantee?

A. That is the examiner's report of title and is the basis on which a preliminary report is issued by the company, stating that as of a certain date a particularly described piece of property is vested

(Testimony of Jack M. Rolls.)

in a certain name subject to certain objections or clouds on the title which can be of various nature.

Q. Does a title report or title policy serve the same purpose as the work of abstracting the title? I mean, did you not testify that it is not necessary to abstract the title back beyond a title report or a title policy that you already have acquired?

A. That is true in some cases, yes.

Q. Well, then——

A. That is what we call a starter.

Q. So your starter serves the same purpose as if someone were put to the effort of abstracting the title back beyond that, is that correct?

A. That is correct.

Q. However, if you do get a starter it is always necessary to bring the state of the title up to date?

A. Bring it current.

Q. Is that correct? A. Correct. [144]

Q. Now you have some 33 employees, you stated. How many of those people are involved in searching title for abstracting?

A. Well, now, that are involved in—well, it all goes in as part. In other words, maintenance of plant, searches and all the rest is all part of it.

Q. Just approximately. A. 13.

Q. Now, the salaries to those people and the other expenses involved in their work are considered as current expenses of the business, is that correct? A. Yes.

Q. Are you familiar with the MacInerney Act?

A. Yes.

(Testimony of Jack M. Rolls.)

Q. That refers to the fire and the earthquake, right? A. Correct.

Q. Now, did you testify that Petitioner ceased making payments to brokers in about 1955?

A. I didn't testify anything.

Q. Does Petitioner still make these payments to brokers? A. No.

Q. When did they cease?

Mr. Carey: I object. That has no relevancy to this case. We are concerned with expenditures 1952, 1953 and 1954. It is admitted by everyone that they were made in those years. [145] The testimony is for that purpose.

The Court: Objection overruled.

Q. (By Mr. Boyle): Why did you stop making these payments?

Mr. Carey: I object to that on the ground that it calls for a conclusion of the witness.

Mr. Boyle: I believe this witness——

The Court: He is qualified to answer that question. Objection overruled.

A. Because as I recall, the problem came up with the gentleman from the Internal Revenue Department. We just stopped from that time on until this thing is decided.

The Court: That would be in what year?

The Witness: I think it was 1955, sometime in 1955.

The Court: Since this audit was made and these deficiencies determined, you have stopped making payments to real estate brokers?

(Testimony of Jack M. Rolls.)

The Witness: Once the gentleman from the Internal Revenue Department came in and raised the question on the thing, we stopped immediately, right now.

The Court: That would be in 1955?

The Witness: As I recall, I am not positive of that, your Honor. [146]

Q. (By Mr. Boyle): Does the importance of whether you acquire these preliminary title reports or title policies turn upon whether they are allowed as a deduction to you? That is, does the payment to brokers which you have alleged is for the purchase of preliminary title reports and policies, do those payments—or does the importance of making that purchase and acquiring these reports turn upon whether or not you are going to be allowed a deduction for making those payments? Am I confusing you, Mr. Rolls?

A. In other words, are you asking the question—I have got lost, your Honor, there. But perhaps—see if I can get your thought.

The Court: You may in this instance question counsel. We don't ordinarily do that but you don't understand the question. Tell him what you don't understand or ask him to repeat the question.

The Witness: Are you asking if it is still important as far as we are concerned that we be able to purchase these reports?

Mr. Boyle: That is one question, yes.

The Witness: Yes, it is.

(Testimony of Jack M. Rolls.)

Q. (By Mr. Boyle): Why did you stop making those purchases then when the Internal Revenue entered the picture?

A. Because a question was raised and we weren't [147] going to involve or obligate ourselves or have any additional problems until this is determined. That is one reason we are in Tax Court, your Honor.

Q. In other words, if you are not allowed this deduction you just won't buy reports, title reports or title insurance policies, any more? Is that right?

A. We may be able to find some other way of doing it. That I don't know. We will have to have some determination on that, of course.

Mr. Boyle: I only have a little more.

The Court: I understand, Mr. Rolls, that you are interested in whether this Court will make a determination that no part of these payments in the taxable years constituted rebates in escrow fees to brokers?

The Witness: Or a capital expenditure, your Honor.

The Court: Well, now, you could and might continue to make these payments for preliminary reports whether or not you could expense them or had to capitalize them. Isn't that right? Counsel has just asked you about whether or not you discontinued making these payments at some point and you said you did when the revenue agent came in and that was sometime in 1955.

(Testimony of Jack M. Rolls.)

The next question is: Well, don't you need these preliminary reports and you say yes. And then the next question: Why did you stop making the payments that are [148] involved here or the type of payments that are involved here, and your answer was that you decided not to make any of these payments of this kind until after this matter is decided in the Tax Court.

Do you mean to say that if we should hold that payments of this type have to be capitalized that you will not make them any more?

The Witness: I don't hold that, your Honor, but we'd like a determination of exactly what our position is going to be in respect to purchasing those reports.

The Court: Yes, you may want to know that for purposes of accounting and tax deductions on your returns.

The Witness: That is correct.

The Court: Am I to understand that apart from that you are interested in getting this Court to decide whether the payment in question in fact represented rebates of escrow fees? Is that why you are interested in this case in this Court?

The Witness: No, your Honor, we contend that they are not. We have contended all along that they are not. That is the Government's position, that is not our position.

The Court: 1955 apparently is the time when this audit was made. This is getting toward the end of 1958. That is three years. In the meantime, since

(Testimony of Jack M. Rolls.)

1955, have you been able to get any preliminary reports? [149]

The Witness: Yes, your Honor.

The Court: How did you get them?

The Witness: On an understanding that they would give them to us——

The Court: Gratis?

The Witness: Gratis until such time as we would be able to make some determination of payment for them.

The Court: Your next question.

Q. (By Mr. Boyle): Mr. Rolls, I show you Petitioner's Exhibits 2 and 3 in evidence and ask: Do either of those exhibits show from whom the preliminary report or title insurance policy was acquired? A. No.

Q. Does it show the amount paid? A. No.

Q. Does it show when the Petitioner acquired those reports or policies? A. No.

Q. Now, in my opening statement I said you had no way of assembling, identifying or screening these reports or policies and I was referring to the issue in question here, whether you could do so with regard to the acquisition of those reports or policies from any particular broker. Your testimony is that you cannot relate any policy or any report [150] to any particular broker. Isn't that correct?

A. That's correct, yes, because once they are integrated in our system I have no way of going back and recalling from whom we got them.

(Testimony of Jack M. Rolls.)

Q. Mr. Rolls, what differentiates, if it does, the type of information which you acquired and placed in your plant in 1947 through 1951, and the type of information which you acquired in the years 1952, 1953 and 1954, specifically this type of information on these preliminary title reports or policies?

The Court: What is the question?

Mr. Boyle: What differentiates the information, that is, the reports and the policies prior to 1951 and after 1951?

The Court: There might not be any differentiation?

Mr. Carey: What difference would that make? I think it has no relevancy.

Mr. Boyle: They said they capitalized it prior to 1951 and they did not do so afterwards.

The Court: Did you capitalize these amounts prior to 1951?

The Witness: Yes, your Honor.

The Court: Why don't you just ask him a direct question as to why he did. Why did you capitalize the payments in question prior to 1951 and then expense them after 1951? [151]

The Witness: Well, your Honor, let me explain it this way. As I originally did in connection with our competing for title insurance business in San Francisco. In order to equally or semi-equally compete with the other title insurance companies in San Francisco, when we first opened our business they, as I originally said, said that we would not

(Testimony of Jack M. Rolls.)

last six months. We had the opportunity of being able to write title insurance and subsequently started our title plant. The other companies threw up to the lending institutions in this area and to prospective clients the fact that we did not have a title plant. In furnishing a financial statement to various lending institutions in connection with our business, in order to request that they accept policies of title insurance issued through our office, if they did not see, and our initial ones in the beginning of 1947 did not show any amount for title plant, they said then, "Well, you don't show any amount for title plant. How do we know that you have one?"

So we voluntarily started to capitalize our title insurance plant or our title plant at that time. I believe that from the point of view, as Mr. Bass originally pointed out, if we wanted to do what they call hat searching, we could insure titles without a title plant.

The Court: What kind of searching? [152]

The Witness: Hat searching, doing searching of records without the benefit of a title plant.

The Court: All right. You gave that explanation before. So that enabled you to show an amount on your balance sheet for your plant?

The Witness: Right.

The Court: Well, now, get back to counsel's question. That was the reason why you say you capitalized these expenditures up until 1951.

The Witness: Right.

(Testimony of Jack M. Rolls.)

The Court: Why didn't you continue to capitalize them?

The Witness: Because at that particular time we had arrived at a capitalization of \$25,000 which was our originally incorporated capital stock amount and according to the Insurance Code requirements as far as title insurers are concerned, the maximum that they can capitalize is 50 percent of their capital stock and we felt that we might——

The Court: Go over your 50 percent?

The Witness: Over 50 percent as just a title company and we felt that we would limit it to our capitalization because we might be getting into a problem with the Insurance Commissioner, being an underwritten agency, if we went over that. We weren't sure.

The Court: All right. [153]

We will go back to Mr. Boyle's question. Was there any difference in the nature of your records before 1951 and after 1951?

Mr. Carey: I think if the Court please, that was not the question.

The Court: That is what he is trying to get out. He asked how he could differentiate.

Mr. Carey: Between the title information that you acquired when you capitalized it and the title information you acquired when you expensed it.

The Court: All right. That is the question.

The Witness: There was really no differentiation as far as I was concerned, your Honor. It continued to be an expense.

(Testimony of Jack M. Rolls.)

The Court: The information was just the same?

The Witness: The information was just the same. It was maintaining a current plant, your Honor.

The Court: That information you considered as maintaining?

The Witness: Yes, your Honor.

The Court: An established plant?

The Witness: Can I expand on that particular thing a little bit as to why these reports should not be considered as a capital expenditure?

The Court: This is argument and if your counsel [154] wants to add to your opinion about it he will ask you, but in the Court proceeding the witness isn't supposed to volunteer these things. It delays us, for one thing.

What other questions have you, Mr. Boyle?

Mr. Boyle: That is all. Thank you, your Honor.

Mr. Carey: I have just a couple of questions.

The Court: Do you want to give your witness an opportunity to get this off his chest?

Mr. Carey: Yes, I am going to.

Redirect Examination

Q. (By Mr. Carey): Mr. Rolls, would you explain, as an expert in the title business, why the cost of acquiring preliminary reports and title insurance policies to use as starters is a proper current expense or expenditure for plant maintenance as opposed to a capital expenditure to build a plant?

(Testimony of Jack M. Rolls.)

A. Well, the building up of a plant may take ten years or twenty years, depending on the requirements and the individuals involved, but this particular situation is what I was trying to get at, your Honor, is this: That is, if our company wanted to, which we did in many cases when we were not overly busy, put our searchers to work searching back the records for pieces of property in San Francisco and bringing them up current as of that particular date when they were doing the work, so that when we got an order on that [155] particular piece of property we would have a current record as of a certain date and they maintained those records currently right on up. The basis of that is the fact that that does not have to be done. They do not take the time of a searcher. Perhaps we paid—as you asked me a moment ago for a specific amount, Mr. Boyle. Perhaps we paid \$50 for a preliminary report of title or a policy of title insurance. If that were, say, three years old, back in 1955, we could use that as a starter and not have to go back from 1955 perhaps to 1906, which would involve hours of time of a searcher to do that and the cost of a searcher averages about \$2.50 to \$2.75 an hour and a full time search will take anywhere from—we have had them as high as 10 or 15 hours or better than that. So that perhaps the payment of a \$50 fee for one report which would eliminate the cost of going back, you see. Therefore, it cuts down our operating expense and it maintains our plant current on that basis as of that particular time.

(Testimony of Jack M. Rolls.)

Q. Mr. Rolls, a point was made that you might buy a particular insurance policy or preliminary report today and pay for it \$50 but that you might never issue a title insurance policy on that particular piece of property. Your answer was that that was correct, that you might never use that particular piece of title information.

Now, would your answer be the same with regard to the abstract of a deed that is filed today in the office of [156] the County Recorder of the City and County of San Francisco, that you might well never use that information that could be obtained from that deed?

A. That is true. In other words, if you don't have a title plant which is maintained by your current recordings, and no title company in San Francisco regardless of how long they have been here has ever had a search on every piece of property in San Francisco. In other words, your permanent cost of maintaining your plant—again you could say it was a capital expenditure because you may never use them. It is an operational hazard.

Q. Would your answer be the same as to the records you are taking currently from the Court in San Francisco, from the Recorder's Office in San Francisco and these records that are daily occurrences. Some of those may never be used by you, is that correct?

A. That is correct.

Q. But as a practical business matter you have to have them, is that correct?

A. Yes.

(Testimony of Jack M. Rolls.)

Q. Mr. Rolls, I believe the question was asked you concerning the reason for your ceasing to buy preliminary reports and title insurance policies. How large a deduction did you take in 1952 for this purchase of preliminary reports and title insurance reports? [157]

Mr. Boyle: That has been stipulated to, Counsel.

Q. (By Mr. Carey): What effect, if any, would the size of that deduction have upon your administrative decision to purchase or not to purchase—I mean assuming that you could not deduct that amount of money, would it have any effect upon your decision whether to buy these reports or not?

A. No.

Q. If you are not allowed to deduct them, you would continue to buy them?

A. We would have to capitalize them if necessary. I mean these people are giving them to us gratis now.

Q. I believe you testified, Mr. Rolls, that prior to 1951 you paid commissions to real estate brokers?

A. Yes.

Q. What commissions to real estate brokers, if any, did you pay after 1951? A. None.

Mr. Carey: That is all.

Mr. Boyle: I just have one question.

Recross Examination

Q. (By Mr. Boyle): Did you pay your searchers the same salary whether they are searching or they are not searching?

(Testimony of Jack M. Rolls.)

A. They are on a monthly salary. [158]

Mr. Boyle: That answers it. That is all.

Mr. Carey: That is all, Mr. Rolls.

The Court: All right. You may step down.

(Witness excused.)

Mr. Carey: I would like to call Joseph S. Rogers.

Whereupon

JOSEPH S. ROGERS

was called as a witness on behalf of the Petitioner and, having been first duly sworn, testified as follows:

The Clerk: State your name and address for the record.

The Witness: Joseph S. Rogers, Peart, Baraty and Hassard, 111 Sutter Street, San Francisco 4, California.

Direct Examination

Q. (By Mr. Carey): Mr. Rogers, what is your occupation? A. Attorney-at-law.

Q. How long have you been an attorney-at-law?

A. Sixteen years with the exception of World War II and the Korean War.

Q. You are a member of what bars?

A. California, San Francisco, American, Tax Court, and one or two others perhaps.

Q. What relationship, if any, do you have to the Petitioner in this case? [159]

(Testimony of Joseph S. Rogers.)

A. We are the General Counsel for the Petitioner, Bay Counties Guaranty Company.

Q. How long have you been General Counsel?

A. Since its incorporation in 1946.

Q. What other, if any, people dealing with real estate do you represent?

A. Yes. We represent Pacific Coast Title Insurance Company of Utah and California, and we represent Multiple Listing Service of San Francisco.

Q. Did I understand you to testify that you were in the Korean War? A. Yes, that is right.

Q. During that period of time you did not give any advice or did not represent the Petitioner?

A. No, that is correct. So I was in the Korean service and completely separated from the practice of law during the period of—

The Court: All right. That will do. I understand. He is a lawyer admitted to practice. What questions do you want to ask him?

Q. (By Mr. Carey): Directing your attention to Petitioner's Exhibit 4 in evidence, do you recall the occasion for acquiring possession of that or a copy of that ruling, Mr. Rogers?

A. I do. [160]

Q. What was that occasion?

A. There was some discussion concerning the purchase of preliminary reports or policies of title insurance from brokers or lending institutions and before we continued we wanted to have a determination by an official of the State of California as to whether or not the purchase of preliminary re-

(Testimony of Joseph S. Rogers.)

ports or policies of title insurance would be in violation of any California statute. I had learned that such an opinion had been rendered at the request of Senator Thompson and I obtained a copy of that opinion.

Q. Is that a copy of the opinion which you have in your hand which is Petitioner's No. 4?

A. It is a copy, a photographic copy of the opinion signed by Mr. Bernard Czesla who is in the office of the Legislative Counsel, Mr. Ralph N. Kleps.

Q. Was Ralph N. Kleps the Legislative Counsel during the period in question?

A. Yes, he was.

Q. Was Mr. Czesla, to your knowledge, one of his deputies? A. He was.

Q. Based upon this opinion and other opinions, did you give your client some advice concerning this practice of purchasing preliminary reports and title insurance policies from real estate brokers? [161]

Mr. Boyle: Whether he did or didn't would be completely irrelevant and immaterial. Whether he did or not advise them wouldn't make any difference to this case.

The Court: Objection overruled. You may answer the question.

A. Yes. Based on this opinion and other factors we did give such an opinion to our client.

Q. (By Mr. Carey): What was your advice?

A. Our advice to Bay Counties was that their acts in conformity with this letter of opinion writ-

(Testimony of Joseph S. Rogers.)

ten to Senator Thompson were not in violation of any California statute.

Q. Did you satisfy yourself that this opinion had actually been rendered by Mr. Kleps's office?

A. I did.

Mr. Carey: That is all, Mr. Rogers, at this time.

If the Court please, I will offer this Petitioner's No. 4 in evidence.

Mr. Boyle: I object to the introduction of Exhibit 4 for identification in evidence. It is irrelevant and immaterial and has no probative value because it is not based on the facts of this case but on some other hypothetical situation. Furthermore, it is hearsay. The man who wrote it is available. He is in the state and could have testified. We had no chance to cross-examine him with regard to that. [162] In the third place, it invades the province of the Court. It is up to this Court to determine what, if any, violation there has been and it would be of no value for that reason.

The Court: I don't think it is up to this Court to decide whether there has been a violation of this statute. I think there seems to be at issue in this case under one of the questions and it is up to the parties to present evidence on the question.

Mr. Boyle: I don't believe that would do it.

The Court: The question may not have anything to do with whether they violated a statute. By the way, what is the statute? Would you read it? Is it short, could you read it into the record?

(Testimony of Joseph S. Rogers.)

Mr. Boyle: I did read it in my opening remarks, verbatim. I will repeat it if you would like.

Section 12404 of the California Insurance Code. It talks about prohibited commissions.

“No title insurer, no controlled escrow company, and no underwritten title company shall pay to any person who is acting as agent, representative, attorney or employee of the owner, lessee, mortgagee or of the prospective owner, lessee, or mortgagee of the real property or any interest therein, either directly or indirectly, any commission, or any part of its fees or charges or other consideration as an inducement for or as compensation on any title insurance business or any escrow or [163] other title business in connection with which a title policy is issued.”

That is the end of the quotation. Actually this particular law falls under Sections 12401 through 12412 of the Insurance Code. I merely read one pertinent section of it. There are also provisions for criminal penalties and so forth.

The Court: One question in this case appears to be whether, during the taxable years, the taxpayer made any payments which constituted refunds of escrow charges. The escrow charge is made to a person who is a party to a real estate transaction.

Now, let me ask you, Mr. Rolls—just stay where you are—you have in your business closings?

The Witness: Yes.

The Court: Who do you represent, the seller or the buyer?

The Witness: We represent all parties.

(Testimony of Joseph S. Rogers.)

The Court: Who pays the escrow fee?

The Witness: The purchaser.

The Court: Of the property?

The Witness: Of the property, right.

The Court: This provision of the California Code prohibits the refund of a part of an escrow fee. Isn't that right? [164]

The Witness: That's right, yes, your Honor.

The Court: You are claiming here that none of your expenditures in the taxable years constituted refunds of escrow fees?

The Witness: That's right, your Honor.

The Court: That is a determination that was made by the Commission. That is the reason he gave for disallowing these deductions?

Mr. Carey: That is correct.

The Court: You are denying that these amounts constituted rebates of escrow fees, aren't you?

The Witness: That's right, your Honor.

The Court: The question that I have, Mr. Boyle, is whether any of these amounts constituted rebates of escrow fees. That is all I have to determine.

I am not going to make any determination—I don't have before me a question of whether there has been any violation of California statute. That is maybe drawing the line a little fine but I just thought I would point that out to you. If you want to argue this—Exhibit 4 is admitted in evidence over Respondent's objection.

(Petitioner's Exhibit No. 4 was received in evidence.)

The Court: Of course, if the taxpayer was—you know what the Lilly case is? [165]

Mr. Boyle: Yes.

The Court: All right. In the Lilly case it may have been admitted that there were rebates to doctors for referring business to opticians. It may all have been admitted. The question was whether an expense of that kind was deductible as an ordinary and necessary business expense. The Supreme Court held that it was. The Tax Court held that it was not. If you want to find out whether the Lilly case would apply here, you might bring in this matter of the California statute, but I would feel that you would have to prove—if you have a question of whether there has been a violation of California statute here, you would have to prove it here in the Court room, and not just argue it on briefs.

Mr. Boyle: If the Court would make a basic finding that they were paying commissions, that these payments to brokers after 1951 were the same as before, then the Court could find that the payments were not actually for buying any documents but were a part of the escrow fee, and if that were so it would seem the next step would be for the Court to say that that violates the statute.

The Court: You are not proving that it would violate the statute. You are not bringing in anyone to testify as to what a violation of that statute is. You want me to decide what a violation of the statute would be.

Mr. Boyle: The only question for you would be whether they were actually making a kickback or

a rebate. The statute is clear. The Petitioner says he was not doing that, he was buying something. If the Court finds that was not actually the case, that he was not buying anything but was making a percentage payment of an escrow fee, that would seem to be clearly a rebate or kickback under the local law. That is the first question.

The Court: You consider, Mr. Boyle, one question in this case. That question is whether in the taxable years, Mr. Rolls was making a payment of a certain percentage. He is making a payment which represented a certain percentage.

Mr. Boyle: Yes, the record will show——

The Court: Of escrow fees. I have told you before that I will not have you just rely on those exhibits. I want testimony on the point. Are you going to put your agent on the stand?

Mr. Boyle: I would be very glad to.

The Court: I didn't ask you whether you would be happy or sad about it. I didn't ask you to state what your emotions on the subject were.

Mr. Boyle: I did not intend to.

The Court: Thank you. That is an answer to my question. Until you prove that these payments in issue represent a certain percentage of something, this Court will not make a finding of fact on that. [167]

Mr. Boyle: We can do that on brief.

The Court: You cannot do that on brief. Mr. Boyle, I want you to understand that I am making a ruling. I am not advising you on anything.

Mr. Boyle: May I ask you a question?

The Court: I told you, I guess early today, what my requirements would be and I mean it. That is a Court order, if not a ruling. You are either going to prove it here in the Court room or it is not going to be considered. Now, can I make myself any clearer, Mr. Boyle, or not?

Mr. Boyle: If the Court please, I say again that the evidence before the Court will show the amount of every escrow fee paid in the years under consideration.

The Court: Where is it?

Mr. Boyle: It is in Respondent's Exhibit E.

The Court: Where is it in E? How many pages are there in E?

Mr. Boyle: Twenty pages in E.

The Court: Get back away from the bench where you should be, back by the counsel table.

Mr. Boyle: Respondent's Exhibit E is a record kept by Mr. Rolls.

The Court: You have not put into this record anything more than one reference to one payment which was made in January of 1951, I think was the one that you picked out. [168]

Mr. Boyle: I asked the witness——

The Court: Your exhibit is not prepared. You are not prepared to present that to us and you are going to insist on waiting until you file your brief to make some kind of a table up. In the meantime you have an agent here in the Court room who made a report. He examined the very document that you have in your hand, which is Exhibit E. He made a calculation and an analysis from

Exhibit E. He put the conclusions and finding from that analysis in his report, and yet you come into this Court and refuse to put your agent on the stand.

Now, it is a quarter of 5:00. We will recess the trial of this case until tomorrow morning and tomorrow you will do as the Court directs. Now, that is all.

It is up to you to decide whether you are going to call a witness or not. It is also up to you to decide whether you are going to comply with the ruling of the Court, but I can tell you one thing, that my ruling is that there is not one bit of evidence that I have heard or that I can read which establishes that any payments were made at any time that constituted a certain percentage of an escrow fee. Somebody might be able to surmise that from making an analysis of an exhibit.

It might be an inference to be drawn. I might be a deduction to be drawn, but that is not the way you try a law suit. [169] You prove it here in the Court room. You give your opponent the opportunity to say, "Well, it may appear to you that this is five and this is four and five times four is twenty. But I am going to put on evidence in this case to prove to you that this is not five, and what you have here is four times four and that is sixteen, and I am going to prove it."

That is the way a lawsuit is conducted. You give your opposing counsel an opportunity to rebut what you think you are showing and you don't leave it

until you file a brief and then ask this Court to make a deduction about something.

Now, I am not—I may as well sit down and finish this—I am not willingly going to decide any question about a violation of a California statute unless somebody comes into Court and proves it. I mean, takes the witness stand and says it. I am not going to allow the Tax Court to be used as a forum in a tax case to decide that someone engaged in the real estate or title abstract business here has violated a California statute.

We are here to decide what the taxpayer's income tax liability is for 1952, 1953 and 1954. Now, in doing so we may run into a question of whether the rule of the Lilly case applies, but I am not going to make inferences from exhibits.

Now, Mr. Boyle, I think the only way that you [170] can comply with the Court's ruling on this matter is to put your witness on the stand, namely, the revenue agent. I think that is fair and if you are going to contend that your Exhibit E shows that payments made during each of the taxable years constituted a certain percentage, usually 10 percent or something like that, of an escrow fee, you make your table up tonight and you bring it in tomorrow and put your revenue agent on the stand and get it into the record.

Mr. Boyle: May we have permission to withdraw Exhibit E for the night?

The Court: You will have to do it and I want you to do it.

Now, too many judges of the Tax Court allow Tax Court cases to be presented as though we were holding more or less an informal hearing and I just won't do that and I don't think the fact that the burden of proof is on the taxpayer means that the Government never has to put on a witness and never has to prove anything. I don't go with that either. What I say is right from the standpoint of how these cases ought to be tried, but I am perfectly willing to tell you that I am driven to insist on the rule because I do not have the time to make analyses of exhibits.

Now, I have heard members of the Tax Bar complain that judges of this Tax Court decide cases on the basis of inferences, that they never mentioned a certain thing in a [171] brief and nobody proposed that a certain fact be found in a brief or nobody made an argument of a certain kind on brief, but the Court seemed to draw an inference from the evidence and so forth.

Sometimes you are obliged to because of the very thing that you have to decide requires that you have certain facts before you and if the parties have not very clearly tried their case so as to prove the necessary and essential facts, the Court is put in the position of having to draw inferences, but it is not the Court's fault.

Other than that, the Court should have insisted at the time that counsel fully try their case.

Now, I want you to take Exhibit E home tonight and make up your table and make up your analysis

and put Mr. Compton on the stand or forever hold your peace. Unless you do it right now in the Court room, don't feel free to make your argument on brief that these payments represented uniformly 10 percent of an escrow amount and therefore represented a kickback of some kind. Maybe your opposing counsel knows that this is your theory. Maybe you have discussed it with him, but it is not on the record here and what is not on the record here I neither see, hear nor think. Never heard of it. But if you get in the record these things, I will have heard of it and I will read it and I will take consideration of it.

Have I made myself clear? [172]

Mr. Boyle: Yes, your Honor, very clear.

The Court: We will recess this case until tomorrow morning at 9:30.

(Whereupon, pursuant to the order of the Court, the hearing in the matter of the above-entitled Petition was recessed until 9:30 o'clock, a.m., Thursday, October 9, 1958.) [173]

Proceedings

The Court: Have you been able to finish the schedule?

Mr. Boyle: If your Honor please, a start has been made. There is not a complete schedule, but

I will put the agent on the stand to show what he has been able to do.

The Court: All right.

Mr. Boyle: Mr. Compton, will you please take the stand?

The Court: What are our exhibits?

The Clerk: E is the last letter, and 4 was the last number.

The Court: Four has been put in evidence?

The Clerk: Yes.

H. JAMES COMPTON

was called as a witness on behalf of the Respondent and, having been first duly sworn, testified as follows:

The Clerk: Please state your name and address for the record.

The Witness: H. James Compton—C-o-m-p-t-on—71 Berens Drive, Kentfield, California.

Direct Examination

Q. (By Mr. Boyle): By whom are you employed?

A. By the Internal Revenue Service in the [177] District Director's Office.

Q. How long have you been so employed?

A. Since 1946.

Q. Are you a member of any professional—are you a professional man? A. Yes, I am.

Q. Are you a lawyer?

(Testimony of H. James Compton.)

A. Yes, sir, I am admitted to the Bar in California.

Q. Are you an accountant?

A. Yes, sir, a C.P.A.

Q. You are a Certified Public Accountant?

A. Yes, sir.

Q. Admitted in California?

A. Not in California. Illinois.

Q. Illinois. Are you the agent that audited the petitioner in this case for the years 1952, '53 and '54?

A. Yes, I am.

Q. Were you in Court all day yesterday?

A. Yes.

Q. You heard all the testimony?

A. Yes, I did.

Q. At the close of the session last night, did I hand you Respondent's Exhibit E?

A. Yes, you did.

Q. Did you bring that back with you this morning? [178]

A. Yes, I did.

Q. Will you please hand it to me?

A. Yes.

Mr. Boyle: Mr. Clerk, I hand you in return therewith Respondent's Exhibit E and ask that you destroy the receipt, please.

Q. (By Mr. Boyle): From that exhibit did you prepare a summarization?

A. Yes, I did.

Q. May I have the summarization?

Mr. Boyle: Mr. Clerk, will you please mark these as Respondent's one exhibit for identification next in order.

(Testimony of H. James Compton.)

The Clerk: Exhibit F for identification.

(Respondent's Exhibit F was marked for identification.)

Q. (By Mr. Boyle): Mr. Compton, I hand back to you Respondent's Exhibit F for identification, which are the two sheets that you handed to me, and ask you to explain that exhibit, please.

A. Yes, Mr. Boyle. This is an analysis of the information contained on Government Exhibit E, which is the monthly record of payments made to brokers by Mr. Rolls for the years 1952 to 1954. This analysis lists in the first column the names of realtors as listed by Mr. Rolls on his monthly schedules. In the first money column it listed the [179] red totals on the schedule, which have been explained to me by Mr. Rolls to have been the amount of escrow fees earned by the petitioner during the month through the efforts of the particular broker whose names are listed. And in this second money column I listed the amounts paid to the broker by Mr. Rolls in currency.

These amounts total for each month the amount withdrawn by Mr. Rolls in column C, which my examination showed to have been charged in most of the months to advertising, and I believe there were five or six months in 1952 where they were charged to photoplant expense, on the expense account of the petitioner.

The Court: What would photoplant be?

(Testimony of H. James Compton.)

The Witness: It is an operating account, and operating expense.

The Court: What does it mean, photoplant?

The Witness: I am not exactly familiar with it. I presume——

The Court: How do you spell it?

The Witness: Photoplant expense.

The Court: P-h-o-t-o?

The Witness: P-h-o-t-o. I presume they photo the documents recorded in the recorder's office.

The Court: Photostat department, or something. All right. Go ahead. [180]

The Witness: Now, in my listing of the names of realtors——

The Court: Let me see that other set.

The Witness: ——I listed every name as listed by Mr. Rolls for the month of January and February and March in 1952, even though there was no red total and no payment paid to the broker in some instances, but I listed the names nevertheless.

Mr. Rolls explained that the abbreviation OC meant that the business transacted with the petitioner was out of city business, and apparently no payments were made to the broker because it was out of city business. I don't know any other reason.

Mr. Rolls did not explain what the check marks mean, and I am not—He did explain three years ago, but I have forgotten what they mean.

The Court: What does "Total Escrow Fee Earned" mean?

(Testimony of H. James Compton.)

The Witness: That is the total of the fees generated by each individual broker during the month.

The Court: It isn't a very clear heading.

The Witness: The petitioner's income from escrow fees earned.

The Court: On this item of \$144, would that be escrow fee payable to the petitioner?

The Witness: Yes; received by petitioner. [181]

The Court: All right.

The Witness: During the month.

The Court: On business brought in?

The Witness: That's correct.

The Court: All right. Anything else?

The Witness: In the second money column then is listed the payments made to the broker for this month.

The Court: Yes.

The Witness: Mr. Rolls has told me that he paid these columns in Column C.

The Court: And you have figured——

The Witness: I haven't verified it any other way——

The Court: You have over here, then, a percentage of the amount paid?

The Witness: That's my calculation.

The Court: You made a calculation of the amount paid of the percentage of the total escrow fee to——

The Witness: Paid to the broker.

(Testimony of H. James Compton.)

The Court: To the amount paid to the broker. All right.

The Witness: And that is rounded off, since I made it roughly in my head. It may not always work out to exactly 25 per cent, since Mr. Rolls apparently making the payments found that the payments to the broker were to the nearest dollar, both up and down. [182]

Q. (By Mr. Boyle): Does your summary cover all the months in those three years?

A. My summary only covers the first six months of 1952. I have worked on this for six hours and ran out of time since I did not have the records available before last night.

The Court: Yes.

The Witness: Mr. Whitman from the Technical Advisor in the Appellate Division did the same analysis for the first six months of 1954 under my direction.

The Court: All right.

The Witness: And I checked the other months, both since last night and three years ago. They showed exactly the same pattern that—where payments were made to brokers, they constituted 25 per cent of the total fees received through the efforts of this broker by the petitioner, and I have used Mr. Rolls' totals throughout.

The Court: All right. Anything else?

Mr. Boyle: Nothing else. I have no questions.

The Court: You may inquire.

(Testimony of H. James Compton.)

Cross Examination

Q. (By Mr. Carey): Mr. Compton, in 1955 when you made this audit—this was in 1955, wasn't it?

A. Yes, sir. [183]

Q. When you saw this record that her Honor has in her hand, you at that time came to the conclusion that the petitioner in this case had violated the California law and was paying rebate, did you not?

A. Eventually I came to that conclusion based on this type of analysis.

Q. Yes. And when you came to that conclusion, at that point it became fixed in your mind and you have consistently ignored facts to the contrary since that time; isn't that correct, Mr. Compton?

A. I have had no——

Q. No facts to the contrary?

A. No. I have had no dealings with it since September 1955. I have had nothing to do with it.

Q. In preparing this exhibit for identification, you ignored all facts to the contrary and put in there only facts that bore out your conclusion; isn't that correct?

A. I listed, as I explained, the red total amounts.

Q. No, you didn't, Mr. Compton. I believe your testimony was that that column includes totals of escrows paid to Bay counties; not the red figures, but totals of escrows paid to the Bay counties, and it does not, does it, Mr. Compton? This escrows

(Testimony of H. James Compton.)

paid column entitled "Escrows Paid to Bay Counties" is a summary of the red figures not circled on this? [184] A. Correct.

Q. You did not summarize and you did not go back and total the escrows paid to Bay counties, did you? A. No, I did not.

Q. You did not. This was a fact which was not in accordance with your preconceived notion of what this company had done? A. No.

Q. And that's why you did not do that; isn't that correct, Mr. Compton?

A. No, it is not correct.

Q. That is not correct. Mr. Compton, I notice one entry. How much is 25 per cent of six?

A. \$1.50.

Mr. Carey: May I, your Honor?

The Court: Yes.

The Witness: Incidentally, there is one realtor who received $33\frac{1}{3}$ per cent.

Q. (By Mr. Carey): Aren't there several of them? As a matter of fact, you have——

A. Consistently received $33\frac{1}{3}$ per cent, Sachs Realty Company, and I believe——

Q. But you show 25 per cent, don't you, Mr. Compton?

A. No. I showed 33 per cent. [185]

Q. Would you show me? Oh, yes, down here.

A. Sachs Realty in every month for six months of 1952 received $33\frac{1}{3}$ per cent.

(Testimony of H. James Compton.)

Q. May I ask you, Mr. Compton, why opposite Gale Wisher you show \$6, \$2, 33 $\frac{1}{3}$, and opposite Darrell Lang you show \$6, \$2, 25 per cent?

A. As I explained that, it amounts——

Q. But don't——

The Court: Just a minute. Never mind being a prosecuting attorney now. I know that the reporter cannot write down statements of two people talking at one time.

Mr. Carey: I beg your pardon.

The Court: Mr. Reporter, read back what you have of this answer.

(Answer read.)

The Witness: As I explained, the payments are rounded out to the nearest dollar, and the percentage is rounded off within five percentage points, and two per cent of \$6.00 is exactly 33 $\frac{1}{3}$ per cent. And if it had been one and a half dollars of six per cent, it would have been 25 per cent.

Q. (By Mr. Carey): Yes.

A. Since it is rounded off, there is to that extent an error. As I explained, the percentages were done by me by [186] mere observation.

Q. But—— A. Not on a machine.

Q. Isn't it correct that your percentages and your calculations here were deemed to——were done to show a pattern?

A. Well, I don't know. They do show——

Q. In your mind they could?

A. In mind they do show a pattern, that is correct.

(Testimony of H. James Compton.)

Q. You prepared that exhibit with that in your mind that they did show a pattern, and you show only those figures that do show a pattern?

A. I prepared that at the request of——

The Court: What is this? You prepared it at the request of what? Finish it.

The Witness: I prepared the summary, I believe, at your Honor's request, or at the request of Mr. Boyle.

The Court: You prepared it at the request of Mr. Boyle, and the Court directed Mr. Boyle to get his exhibit in shape so that it could be read by the Court. That's what you did.

Q. (By Mr. Carey): Did you ever inquire, Mr. Compton, as to whether such designations as OC, what they meant? A. Yes, I did. [187]

Q. Did you inquire as to whether this was—that the petitioner here received any money through these transactions?

A. Well, I inquired at two different times three years ago. Mr. Rolls explained all the symbols and marks he used on his monthly schedules, and last night I inquired of him, and he was stopped from answering my—in order to refresh my memory of what these abbreviations and symbols meant, I asked him the question, please explain to me, and I believe you or Mr. Rogers asked him not to explain.

Q. Then we also—Didn't we not tell you, Mr. Compton, later?

A. Later on somebody had suggested I call Mr. Rolls.

(Testimony of H. James Compton.)

Q. If you had any difficulties interpreting this exhibit; isn't that correct?

The Court: Read the question.

(Question read.)

Q. (By Mr. Carey): Isn't that true?

The Court: Well, go ahead.

Q. (By Mr. Carey): Isn't it true that we also informed you that if you had any difficulties interpreting Exhibit E that you were to call Mr. Rolls, and he would aid you in that interpretation?

A. That was stated later on in the hall, in the doorway.

Q. That is correct. [188]

A. That's correct.

Q. Isn't it correct that your counsel, Mr. Sears, told you that you were not to contact Mr. Rolls?

A. Yes, sir.

Mr. Carey: That is correct. I think we have no further questions.

The Court: This exhibit can be completed, Exhibit E, and totals run up on an adding machine. You may step down.

(Witness excused.)

The Court: Do you want to ask Mr. Rolls to explain this thing any further?

Mr. Carey: No, your Honor.

The Court: Do you have another witness?

Mr. Carey: No, your Honor.

The Court: Do you have another witness, Mr. Boyle?

Mr. Boyle: No, your Honor.

The Court: Then you both rest, is that it, except for finishing this tabulation for the Court?

Mr. Boyle: At the beginning of the trial, the Court requested that the parties prepare something like this and type it completely and put it in the case.

The Court: This would amount to the same thing. This exhibit.

Mr. Boyle: I offer in evidence Respondent's F for identification. [189]

Mr. Carey: No objection.

The Court: F is received in evidence.

(Respondent's Exhibit F was received in evidence.)

The Court: Mr. Rolls, you have been sworn. You can remain seated where you are.

Exhibit E and Exhibit F give us the names of many real estate brokers. Now, there probably are duplications of names. The same name probably appears more than once.

Mr. Rolls: Each month. They appear once each month, your Honor.

The Court: They appear once each month?

Mr. Rolls: Yes.

The Court: Now, in each instance did you obtain a preliminary report or some copy of the title report from that broker?

Mr. Rolls: Yes, your Honor.

The Court: Will you give us the dates for the briefs, please?

The Clerk: Simultaneous briefs will be due on or before November 24. Reply briefs will be due on or before December 24.

The Court: May I see Exhibit 4? I guess it is 4. What is 5?

Mr. Carey: There is no Exhibit 5. [190]

The Clerk: There is no 5.

The Court: No Exhibit 5.

Mr. Carey: I beg your pardon. There is an Exhibit 5, your Honor, but that was withdrawn by me with your consent to prepare a summary. It was all of the daily ledger sheets, and we were going to prepare a summary which will show just the expenditures.

The Court: Please don't withdraw any exhibits until we get to the end of the trial, because I have to make arrangements to get that exhibit back, and so forth.

Mr. Carey: Yes, your Honor.

The Court: Now, will you check Exhibit—That may have happened in connection with some others. My record is we have joint Exhibit 1-A. Didn't I check this with you?

The Clerk: Yes, your Honor. I don't see 1-A, unless it is on your desk.

The Court: Here are some returns.

Mr. Boyle: 1-A are the Articles of Incorporation, and we withdraw that to make a copy of it.

The Court: You must not withdraw exhibits during the course of the trial. Now, it's too bad to go over this with you just once, I am sorry, the system we operate under, but if I didn't stop to check this

business, I wouldn't know where my exhibits were. Who has Respondent's Exhibit 1-A?

The Clerk: I have a receipt signed by Respondent [191] for that exhibit, your Honor.

The Court: Do you have B?

The Clerk: B, C and D are the returns, your Honor.

The Court: You have those?

The Clerk: Yes.

The Court: You have E and F?

The Clerk: Yes.

The Court: Do you have 2 and 3?

The Clerk: Well, I have 2.

The Court: Well, find 3, please.

The Clerk: Yes. I have 3.

The Court: Four is up on the bench, and 5 has been withdrawn. Do you have a receipt for 5?

The Clerk: Yes, your Honor.

Mr. Boyle: May it please the Court, is 4 that letter to the State Senator?

The Court: Yes.

Mr. Boyle: I don't recall the Court ever ruled on my objection to that. Did you rule?

The Court: I received it over your objection.

Mr. Boyle: Well, then, I note an exception.

The Court: All right.

Now, Mr. Carey, I want to ask you what the position is about these payments to the brokers.

Mr. Carey: In what respect, your Honor? [192]

The Court: What is the status of those payments and what is the relevancy of Exhibit 4 to those payments, and so forth? What is your position?

Mr. Carey: First of all, what are those payments, those are payments in purchase of preliminary title reports and/or title insurance policies from these respective brokers. These are ordinary and necessary expenses of maintaining this title plant in its current operable condition. They add nothing to the plant, but they made—are in the same category as maintaining the plant operable by photographic abstracts of title or title documents currently.

May I point out this, your Honor, that once you have one of these as of a certain date that you use, the title plant beyond that point is no good. You don't refer to it at all. You start with this preliminary report. So that it replaces something that you are currently obtaining at our expense. Insofar as that opinion is concerned, if the——

The Court: Exhibit 4.

Mr. Carey: Exhibit 4 is concerned, if the Court please, since the United States—or since the respondent here has taken the position and consistently throughout the administrative proceedings took the position, and almost exclusively the position, that we have violated the law in buying these reports——

The Court: That would be the California law?

Mr. Carey: California law—that these were illegal expenses, and under the recent cases of the Supreme Court, if they were in violation of law, not deductible because not ordinary and necessary. And, of course, when this was going through the administrative proceedings, these current cases like Tank

Truck Rentals, Inc., versus Commissioner, had not yet been decided, and the reliance of the Commissioner was upon the Lily Case.

The Court: I think you haven't finished off your thought. Now, with respect to Exhibit 4, Exhibit 4 is dated October 27, 1953.

Mr. Carey: Yes, your Honor.

The Court: And this opinion from the Legislative Council of the State of California states what?

Mr. Carey: It states several things, your Honor, that we believe that show our position in this matter.

First of all, it states that petitioner in this case is not——

The Court: It does refer to this petitioner?

Mr. Carey: No, it does not refer to petitioner. It refers to a widespread problem in the State of California and the attempt of title companies to solve the problem, and whether it — within the framework of the California law.

The Court: Well, now, it may be better—you are not looking at Exhibit 4. Maybe I had better help you with [194] this.

May I have that blue-bound book on your desk, Mr. Boyle?

Mr. Carey: I am aware——

The Court: I know that. All right. Remember that we are talking to a reporter.

It appears that paragraph, or Section 12,404 of the Insurance Code of the State of California was enacted in 1949. Is that your understanding, Mr. Boyle?

Mr. Boyle: I understand it was 1951. It was amended in '51. It was originally put in in 1949, and then they put more teeth into it in '51.

The Court: Amended in '51. Well, now, this edition would not show that at all. So I think we will have to have some agreement, for the benefit of the Court, that paragraph 12,404 of the Insurance Code, which has been read into the record twice, is the provision that existed in 1951, '52 and '53, which are the taxable years. Is that right?

Mr. Carey: That's correct.

Mr. Boyle: '52, '53 and '54 are the taxable years.

Mr. Carey: It was in existence and reads as Mr. Boyle read it into the record. The taxable years——

The Court: That provision was in the Code.

Mr. Carey: Yes, your Honor.

Mr. Boyle: Well, I think all those provisions [195] dealing with this subject were in the law at this time. It runs from 12,000——

Mr. Carey: ——401 to 12,412.

Mr. Boyle: Yes.

Mr. Carey: They read as they read in that volume.

The Court: Then on October 27, 1953, someone in the office of the Legislative Council for the State of California in Sacramento gave some opinion to a member of the Senate of the State of California, and in this opinion the problem is stated as a question, a conclusion is stated, and then the reasons are given for the conclusion.

Mr. Carey: Yes, your Honor.

The Court: Now, in the question reference is made to Sections 12,404 and 12,405.

Mr. Carey: That is correct.

The Court: And those provisions have been brought to the attention of this Court. So the person who made this opinion came to the conclusion that under 12,404 and 12,405 it was not illegal to make a payment for——

Mr. Carey: Purchase of the——

The Court: ——purchase of a document of title upon the basis of which the policy of insurance was issued.

“Thus, the cost to the insurer”—I am now quoting this opinion—“Thus, the cost to the insurer of purchasing a copy of an old title insurance policy would be a charge [196] which would be included in the schedule fees adopted by the insured pursuant to Section 12,401. The prohibition of Section 12,405 is to be rebate of any part of this fee.”

Mr. Carey: And I would like to particularly call your Honor’s attention to the first paragraph of that opinion and the concluding paragraph of the opinion.

The Court: The first paragraph on what page?

Mr. Carey: Page 1.

“You state that it has become a common practice for the newer title companies which did not have reciprocal policy exchange privileges with older companies to purchase copies of old title insurance policies or preliminary reports from real estate brokers for the purpose of facilitating their own title

examinations and thus eliminating the necessity of searching the record prior to the date of said purchase policy or report."

And the concluding paragraph:

"It therefore appears that such statements, whether or not made to a broker interested in the transaction, would not violate any provision of the insurance code relating to rebates, but would constitute a legitimate cost of doing business in procuring title information on the basis of which the policy of title insurance is issued."

The Court: That's a quotation also?

Mr. Carey: Yes, your Honor. [197]

Excuse me, your Honor. I was otherwise engaged when the Clerk told us the briefs. Do I understand simultaneous briefs, with the opening briefs, or *seriatim* briefs?

The Court: I will come back to that in a few minutes. We, under our rules, have simultaneous briefs.

All right, Mr. Boyle.

Now, sometime during the week, Mr. Boyle, you can have that schedule completed, which is Exhibit F, and is a—really, it is a copy of Exhibit E, but it's put in more readable form. It is really difficult to read Exhibit E as it stands.

When you have finished that, do you want to see it, Mr. Carey?

Mr. Carey: If I may, if the Court please, yes.

The Court: Well, then, will you make arrangements with Mr. Boyle to see it and bring it in on Monday?

Now, you can decide whether you will both come in, or whatever you want to do. I will leave that up to you.

Now, about the ledger sheet, Exhibit 5. What are you going to do with those, Mr. Carey?

Mr. Carey: We, your Honor, are preparing summaries of only the entries relating to these expenditures here in question, and they are to be complete entries. They show the check number, the date of the check, the payee of the check, the amount of the check, and the account to which credit, and [198] any explanation shown by the ledger sheet, but only as to these monthly checks relating to the cost of title reports.

The Court: Exhibit 5 is made up of the original ledger sheets in an account called Advertising Expense, right?

Mr. Carey: No. It is a daily ledger sheet of the——

The Court: Oh, it is a daily ledger.

Mr. Carey: In a single entry bookkeeping system for three years, your Honor.

The Court: All right.

We will put it this way: Exhibit 5, then, are the ledger sheets for the three years involved here.

Mr. Carey: Yes, your Honor.

The Court: In other words, you are giving us that whole accounting record?

Mr. Carey: Yes, your Honor.

The Court: Only part of it is relevant to the question we have to decide.

Mr. Carey: That is correct.

The Court: And the Court has requested that you make up a schedule from Exhibit 5 which will show just the figures that relate to the issue here.

Mr. Carey: Yes, your Honor.

The Court: Or the entries that relate to the issue here.

Now, Mr. Boyle will also want to check that supplement [199] to Exhibit 5. It will be made part of Exhibit 5. That job has to be done, and we are getting close to the week-end. I think that it would be better if you both bring in these additional summary exhibits on Tuesday. That will give you a chance to have them checked on Monday. You can do your work in the meantime.

Now, one more thing. In a motion for continuance signed by petitioner on January 20, 1958, it was stated that there were pending Hoover Motor Express Co., Inc. v. United States in the Sixth Circuit, 241 F 2d, I guess, 459, where reference was made to Hoover Motor Express Company and Tank Truck Rentals, Inc. Each case at that time had been decided. One had been decided by the Sixth Circuit, and one had been decided by the Third Circuit, and certiorari had been granted in 1957, and you were waiting for a decision by the Supreme Court.

Mr. Carey: Yes, your Honor.

The Court: Now, I am pretty sure those cases have been decided since then.

Mr. Carey: They have.

The Court: Tank Truck Rentals I know has been. What is the reason for your reference to

those two cases? Now, what is your position at the present time?

Mr. Carey: Well, your Honor, as you may recall, there was a great deal of discussion in the Tax Bar on the [200] question of the deductibility of fines and other penalties paid in transacting business on those two cases. In one case, there was a deliberate violation, because they contended they could not do business otherwise, of traffic laws, load limit laws.

In the other of the cases, there was an unintentional, or a violation they couldn't help, because as a truck would be unloaded or loaded, there was no access to scales. They would violate the load limit on certain axles, and so forth, and be subjected to fines because of that.

The Supreme Court had never directly ruled upon this question.

Now, we asked for a continuance because if the Court had ruled that even though they were—the activities were illegal under State law, that if they were otherwise ordinary and necessary, then a long line of lower court decisions would have been overruled and——

The Court: How did the Supreme Court decide Hoover Motors?

Mr. Carey: They decided both of them that fines and penalties made by taxpayers were not ordinary and necessary business expenses and were not deductible.

The Court: All right.

Mr. Carey: They might have helped us, but we don't believe they hurt us.

The Court: They don't help you. [201]

Mr. Carey: They don't help us, but I don't think they hurt us, either.

The Court: Very much.

Have you given us the dates for the briefs?

The Clerk: Yes. November 24 and December 24.

The Court: Well, you both file your original briefs on the first date, and you both file your reply your reply briefs on the next date.

Mr. Carey: Thank you, your Honor.

The Court: Thank you very much for your compliance with the various requests of the Court. That concludes the hearing of the case of Bay Counties Title Company. The Clerk will have a few things to do with the exhibits.

We will take a short recess before calling the next case.

(Whereupon, pursuant to the order of the Court, the hearing in the matter of the above-entitled petition was adjourned indefinitely.)

[Title of Tax Court and Cause.]

Proceedings

The Clerk: Docket 63623, Bay Counties Title Guaranty Company.

Mr. Boyle: If your Honor please, as you will recall, the Respondent has to file Exhibits E and F, the

photostatic copies of the Exhibits E and F, and we are prepared to do that. And I believe the Petitioner has Exhibit 5 also to file.

The Court: May I see Exhibits E and F?

Mr. Boyle: Yes, your Honor.

The Court: If I recall, Exhibit F was made up from Exhibit E. Is that right?

Mr. Boyle: That is correct. There should be no reason to refer to Exhibit E except in order to check the method or the manner in which the agent computed it.

The Court: Well, for the record, Exhibit E was an original record kept by Mr.——

Mr. Carey: Rolls.

The Court: And Exhibit F is a transcript of Exhibit E, setting forth the names and figures on Exhibit E in columnar form, with appropriate headings at the top of the columns. So because Exhibit E would have been too difficult to read and Exhibit F can now be read, also you have totaled columns on Exhibit F.

Now, let me see about the period covered. We [205] begin with the year 1942——

Mr. Boyle: '52, your Honor.

The Court: I mean '52; and we have the year '53—is this next supposed to be '54?

Mr. Boyle: And through '54, through December of '54.

If your Honor please, we would——

The Court: Mr. Carey, are you satisfied that Exhibit F properly reflects Exhibit E? Are you going

to have a photostatic copy, or are you going to be able to check it?

Mr. Carey: They have supplied me with a photostatic copy so that I can check it.

The Court: Then, let's let it stand this way: If you should find any errors when you make your check, and you should stipulate with Respondent's counsel what I am to correct on the Court's copy of Exhibit F, you can enter into a stipulation and just send it up with a motion to receive the stipulation; and the motion would be granted, and then I would make any correction that I had to make on Exhibit F.

Exhibit F has been admitted in evidence, Exhibit E has been admitted in evidence, and over the interval the photostatic copies were to be made. I think that Exhibit F had not been completed the other day during the trial, I had [206] requested that something be done, and it just couldn't be completed; is that correct?

Mr. Carey: That is correct.

Mr. Boyle: Yes.

Is this copy easier for you to read, your Honor, this original copy? If it is, we could leave the original of Exhibit F with the Court.

The Court: Do you need the original?

Mr. Boyle: No, we do not.

The Court: And you can work with your copy?

Mr. Boyle: Yes, we can.

The Court: Well, then, leave the original and the photostat. Then, if I am in doubt about anything, I can refer to the original.

And at the appropriate time you can ask to have this returned to you.

Mr. Boyle: Yes, your Honor.

The Court: We don't return exhibits pro forma; the parties have to request that Exhibit be returned. Keep that in mind. Otherwise these exhibits will stay in Washington for an indefinite length of time. The Court has to operate in that way because of the expense of postage. Our postage cost is one of our very highest expense items. So the reporters have to take care of the postage, I believe, to return exhibits. [207]

Is there anything else about these two exhibits?

Mr. Boyle: It would probably be preferable to put in one more summary which the agent has prepared in order to make those totals come out to the amounts disallowed; and that is necessary because the payments were made in the month following the month of the escrow transaction. Therefore, it may be necessary to have the Revenue agent explain that.

The Court: Well, that carries the whole idea that the Court had through to the end. It is this summary that will be the most helpful, I expect.

Yes, I would like you to show that to Mr. Carey——

Mr. Carey: I have a copy of it, your Honor.

The Court: All right, do you want to have the agent take the stand?

Mr. Boyle: Will you take the stand, Mr. Compton.

The Clerk: He has been previously sworn.

Whereupon

H. JAMES COMPTON

heretofore called as a witness on behalf of Respondent, having been previously sworn, testified further as follows:

Further Direct Examination

Q. (By Mr. Boyle): Mr. Compton, I show you a document——

Mr. Boyle: Would you mark this for identification, please, the exhibit next in order. [208]

The Clerk: Exhibit G for identification.

(Respondent's Exhibit G was marked for identification.)

Q. (By Mr. Boyle): Mr. Compton, I show you Respondent's Exhibit G for identification and ask, did you prepare that document?

A. Yes, I did.

Q. Would you please explain it?

A. This is merely a listing of the totals contained on the large Exhibit F, arriving at an annual total which agrees with the amounts disallowed in the 90-day letter.

Q. Directing your attention now to this adjustment in December of 1952, and also December of 1951, would you please explain why those adjustments were necessary?

A. The total for December 1952, as shown on Exhibit F, was paid not until January 1953, and therefore the disallowance took place in the 1953 total. And the same is true with respect to De-

(Testimony of H. James Compton.)

cember 1951, the payment was made in January 1952, whereas Exhibit F does not contain a listing of December 1951.

Q. Therefore, were those adjustments in Respondent's G for identification—the totals on Exhibit G for identification now conform with the totals disallowed in the statutory notice, is that right? A. Yes, they do. [209]

The Court: Let me see if I get that.

The Petitioner, Bay Counties, keeps its books on a cash basis?

Mr. Boyle: On the accrual basis. But, if your Honor please, the escrow transaction would occur in one month and the real estate broker would be paid in the following month.

The Court: Well, that would—this Exhibit G for identification looks as though you are handling this on a cash basis.

Mr. Boyle: Well, for this purpose it doesn't matter, because it was disallowed as if it were on a cash basis, it was disallowed in the month paid. But Mr. Rolls' personal records would show the broker to whom the amount was paid on the prior month.

The Court: Just hold that a minute.

Exhibits E and F show the payments that were made by Bay Counties?

Mr. Boyle: That is correct.

The Court: And your examination satisfies you that usually the payments were made after a closing, usually the next month?

Mr. Boyle: I think that is a fair statement.

(Testimony of H. James Compton.)

Is that so, Mr. Carey?

Mr. Carey: Of course, we disagree with your interpretation [210] of what this was. But it is true that if you were to examine E and F and relate them to the checks drawn by Bay Counties, that the check would be drawn in the succeeding month. And I presume the payment would have taken place in that succeeding month, insofar as I know, or thereafter.

The Court: In making the determination, that has been made by the Commissioner, you disallowed a total amount of payments which actually were made in the years '52, '53 and '54, and in order to do that, you took into account some items which are recorded in the month of December of the preceding year, but which are paid after December, in the succeeding year, and it is only the December item that you are interested in. So what is recorded on the book as a transaction in December '52 is included in the total for 1952 because it was paid in January, or at least after December. And correspondingly, for December '52, an item that is recorded as connected with a transaction in December '52 falls over into 1953, there is a lapover of the December item into the succeeding year—that is what you mean?

Mr. Boyle: That is true, your Honor——

The Court: I am asking you if that is what you mean.

Mr. Boyle: That is what we mean.

(Testimony of H. James Compton.)

The Court: I am trying to get the record so that I can read it, that is all. I am only repeating what you [211] said. I don't want to argue about it. If what I say is correct, that is all I want to know. So far you agree, is that right?

Mr. Boyle: I do, your Honor.

The Court: What is the "but" about it? I will give you a chance to say something later. Is that all right?

Mr. Boyle: Yes, that is all right.

The Court: All right. We do not have in our record your cancelled checks, and we don't want to have them unless we need to have them. I am again speaking now for our record, for my own use later.

I understand from Mr. Compton that he examined cancelled checks showing these payments, or not. What is the fact on that?

The Witness: I didn't actually examine the checks, but I am satisfied such a check was drawn and Mr. Rolls cashed that check. And according to Mr. Rolls, he disbursed the funds obtained monthly to the various realtors listed on Exhibit E and Exhibit F.

Mr. Boyle: He did that in currency?

The Witness: He paid that in currency.

The Court: That is right.

I want to get back to a few of the details that we were involved in with respect to this case last week. I have been hearing some other cases. I want to get a little [212] of this back into my own mind. Just hold that a minute, now.

(Testimony of H. James Compton.)

On the books in the account advertising expense, is the entry showing the checks that were drawn by Bay Counties to cover these payments that Mr. Rolls made in cash?

The Witness: (Nods affirmatively.)

The Court: On Exhibit E we find in red figures a good many items. Now, do we have in the record anywhere so far anything to show the total amounts of the checks that were drawn, that were charged to advertising expense, the proceeds of which were used to make payments in cash? And I am trying to be careful about my use of words because of the issue involved.

Mr. Carey: Yes, your Honor. That is Petitioner's Exhibit No. 5, which is the day-to-day single-posting ledger of the Petitioner's books.

The Court: All right.

Mr. Carey: Which your Honor permitted me to withdraw to prepare a summary showing only the checks which were drawn and the detail of the account charged and the date and the number of the check, and so forth.

The Court: Well, now we get to the point of comparing the figures for each of these years as shown by the advertising expense account. That would be a logical comparison to make. But I have to inquire about that matter in relation to this little point of carrying over an item from [213] December into the next year that you have been talking about. The two sets of figures may not agree.

For example, Mr. Carey's summary of Exhibit 5—is that this one?

Mr. Carey: Yes, ma'am.

The Court: That shows total checks drawn in 1952, \$6,896. Well, I find that that figure does check with the summary figure shown on Respondent's Exhibit G. And now I think I get it.

Now, are we going to need the original ledger sheets, Exhibit 5, or will this summary be sufficient?

Mr. Boyle: That would be sufficient.

Mr. Carey: I think the summary will be sufficient. That was my understanding.

The Court: Then, this summary is going to be marked Exhibit 5 in lieu of the ledger sheets.

Mr. Carey: That is right.

The Court: Will you mark this Exhibit 5 in evidence, please.

In that situation, it will not be necessary for the Court to have the original ledger sheets, and I prefer not taking them anyway.

The Reporter: Was there a previous Exhibit 5 marked and received?

The Clerk: Yes. This is in lieu of the previous one. [214]

The Court: This is in lieu of Exhibit 5.

(Petitioner's Exhibit No. 5 was marked for identification and received in evidence.)

The Court: Was there something else you wanted to cover?

Mr. Boyle: I wish to offer in evidence Respondent's Exhibit G for identification.

The Court: Any objection?

Mr. Carey: No objection.

The Court: Exhibit G is received in evidence.

(Respondent's Exhibit G was received in evidence.)

Mr. Boyle: That is all that Respondent has, except that we will file with the Court our photostatic copies of the returns which we took out.

The Court: Yes.

Mr. Boyle: Also the articles of incorporation which we photostated and will attach to the stipulation of facts.

The Court: Those are a few details you can take care of with the Clerk.

Was there something you wanted to say in connection with my summary a few minutes ago when I asked you to hold off a few minutes?

Mr. Boyle: At one point, at that point, I thought possibly I could explain it a little more quickly; but I [215] think now that it is understood by the Court and I will just say this: The cash record is a record of the corporation, and it shows the amount that the agent disallowed and the amount appearing in the 90-day letter. Exhibit E, which shows the detail of where that money went, was a personal record of Mr. Rolls. And he had marked, after he made the payment, he apparently then inserted the figures, and since the payment related to something that happened in a prior month, that is why we get the lapover at the end of those years. But it is only by way of explanation, and there

is no confusion between the parties as to the amount paid or disallowed in the years under consideration, nor any confusion on the records of the corporation, itself, as to what that amount is.

The Court: Very well. Is there anything further?

Mr. Carey: Not for Petitioner, your Honor.

The Clerk: Brief dates have been set already, your Honor.

The Court: Brief dates have been set.

We will not take care of the matter of substituting photostatic copies of the exhibits for the originals on the record. We usually do not. That is something for you to work out with Mr. Baird, the Clerk. So we can now say that the trial of this case is concluded.

Mr. Carey: Thank you, your Honor. [216]

(Whereupon, at 10:15 o'clock, a.m., Tuesday, October 14, 1958, the hearing in the above-entitled matter was closed.) [217]

[Endorsed]: T.C.U.S. Filed October 29, 1958.

[Endorsed]: No. 17050. United States Court of Appeals for the Ninth Circuit. Bay Counties Title Guaranty Co. (formerly Bay Counties Escrow Co.), Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Petition to Review a Decision of The Tax Court of the United States.

Filed: August 15, 1960.

Docketed: August 22, 1960.

/s/ FRANK H. SCHMID,

Clerk of the United States Court of Appeals for
the Ninth Circuit.

In The United States Court of Appeals
For The Ninth Circuit

No. 17050

BAY COUNTIES TITLE GUARANTY CO.
(formerly BAY COUNTIES ESCROW CO.),
Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Appellee.

STATEMENT OF POINTS TO BE RELIED
UPON BY APPELLANT

To the Chief Judge and the Honorable Circuit
Judges of the United States Court of Appeals
for the Ninth Circuit:

Comes Now appellant and states the points upon
which it intends to rely in the Appeal filed herein,
as follows:

I.

The Tax Court erred in determining that the preliminary title reports and old title policies purchased by the appellant in each taxable year had a useful life beyond the year of purchase which extended until such years as appellant might make use of them in its own up-to-date title abstracts relating to the same pieces of property in connection with future transactions dealing with them.

II.

The Tax Court erred in determining that the future time of use in appellant's business was problematic and indefinite depending upon when, as and if the appellant might be called upon to make abstracts of title to the same pieces of property.

III.

The Tax Court erred in determining that the old preliminary title reports and old title policies constituted additions and betterments to appellant's title plant, and the expenditure for them was a non-deductible capital expense.

IV.

The Tax Court erred in determining that the expenditures were not current maintenance expenses within the category of ordinary and necessary business expenses.

Dated: August 29, 1960.

PEART, BARATY &
HASSARD,
JOSEPH S. ROGERS,
KENNETH S. CAREY,

/s/ By KENNETH S. CAREY,
Attorneys for Appellant.

Certificate of Service by Mail Attached.

[Endorsed]: Filed August 30, 1960. Frank H. Schmid, Clerk.

